100th Congress
1st Session

SENATE

Report
100-11

THE 1987
JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

JANUARY 1987 ECONOMIC REPORT OF THE PRESIDENT

TOGETHER WITH

MINORITY, ADDITIONAL, AND DISSENTING VIEWS

March 5, 1987.—Ordered to be printed
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[Created pursuant to Sec. 5(a) of Pubic Law 304, 79th Cong.]

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LETTER OF TRANSMITTAL

March 5, 1987.

Hon. Robert C. Byrd,
Majority Leader, U.S. Senate,
Washington, DC.

Dear Mr. Leader: Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit the Report of the Joint Economic Committee. The analyses and conclusions of this Report are to assist the several committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

Paul S. Sarbanes, *Chairman.*

CHAIRMAN'S INTRODUCTION

The Annual Report of the Joint Economic Committee for 1987 surveys a $3.7 trillion economy whose tranquil appearance obscures the danger signals that lie just below the surface. 1986 GNP growth, at 2.5 percent, has been described variously as "sluggish" or "moderate"—not indicative of a sharp downward trend from the previous year's 2.7 percent but not indicative of a health expansion, either. The unemployment rate declined very marginally to 7 percent from 7.1 percent the previous year—in the process falling below 7.1 percent only for the first time since 1980. By year's end, there were signs that the declining value of the dollar might make U.S. products somewhat more competitive in world markets—but the January trade figures reinforced the widespread assessment that the largest trade deficit in U.S. history was not likely to be turned around in the near future. Inflation fell in 1986 to 1.1 percent, the lowest level in 25 years, on the strength of a sharp fall in oil prices—but the Consumer Price Index surged to 0.7 percent in January alone.

The international economy also appeared tranquil—on the surface. The serious strains created by misaligned foreign exchange rates in the industrial world were alleviated somewhat by the Paris agreement in February on currency exchange rates, but a satisfactory resolution cannot be assumed. A major default did not occur among the Third World debtor countries, but the continuing problems in assembling the loan package for Mexico and the announcement by Brazil that it would not be able to meet its debt service obligations indicate that a new stage in the debt crisis could be imminent.

A close inspection of the economy reveals that the current recovery, while long, is fragile, and we are skating on thin ice. This Report sets out warning signs wherever they are warranted.

For example, the slow growth of the past year has been sustained almost exclusively by consumption. Investment has weakened significantly and the current pattern is unlikely to be reversed in the near future, given the recent revision in the tax laws, the substantial excess capacity in manufacturing, fierce international competition, and sluggish corporate profitability.

While consumption has been the spur to economic activity, consumption has been sustained to an extraordinary degree by debt. Households, the Federal Government, and corporations all have taken on debt at record rates in the last few years—households in part because income growth has remained disappointingly low and unemployment stubbornly high. Real wages for production workers have continued to stagnate, and the number of workers wanting full-time work but forced to accept part-time work instead has remained at very high levels.

The rapid expansion of borrowing by all sectors has significantly increased their financial vulnerability in the event of a future downturn. Thus far we have weathered the problems for financial institutions brought about by excessive borrowing, but the urgent requests for rescue packages for both the Federal Savings and Loan Insurance Corporation (FSLIC) and the Farm Credit System underscore the vulnerability of our financial system.

A similar vulnerability is evident in the world economy. World economic growth has been heavily dependent upon the United States' running a large trade deficit, and the prospect of a decline in that deficit sends shock waves through the economies of major exporters. The Third World debt problem reached such proportions that even an Administration once disposed to ignore it came forward in late 1985 with a major policy initiative. While an important recognition of the problem, this initiative does not appear adequate to the task of reducing the financial crisis in the developing world to manageable proportions. Recent developments, with debtor countries unilaterally limiting interest payments, declaring themselves unable to pay interest, and breaking off debt negotiations with the banks, are clear signals of a renewed crisis.

Even in the area of inflation, where the surface indicators have been positive, there are signs of increasing pressure. The Nation has allowed dependence on foreign oil to rise at an alarming rate, exposing the economy to potential future price shocks. The Nation has also relied on the strong dollar and low import prices to help hold down domestic prices, a pattern now being reversed. The sharp jump in the inflation rate in January, while only for one month, is out of line with predictions of a modest increase in inflation in 1987.

In the agricultural sector, once the pride of the Nation and the world, depression-level conditions prevail with little hope of an imminent turnaround.

The potential for disruption in the economy is magnified by the limited range of economic policy tools available to combat any future downturn. The current recovery has been considerably longer than the average for the postwar period and is unlikely to continue indefinitely. At present there are no obvious signs of recession, but a review of past business cycles shows that obvious signs of recession were not generally visible beforehand.

When the next cyclical downturn arrives, the tools available to deal with it will be few and limited. The flexibility of the traditional tools of macroeconomic policy, fiscal policy, and monetary policy has been severely curtailed by the economic policies of recent years. Countercyclical fiscal policy is jeopardized by the enormous structural budget deficits that have actually risen as the economy has come back from the recession, rather than declining as occurred in the past.

Furthermore, the Administration's priorities have not recognized that American's future economic strength depends upon willingness to make prudent investments in a number of pivotal areas, among them education, training and retraining, health, research and development, and physical infrastructure. Failure to do so only sets America back in the effort to build a more prosperous and competitive economy.

Monetary policy is severely constrained by the extraordinary trade deficits of the past several years. Because the United States is now dependent on foreign borrowing to meet its capital requirements, the need to defend the exchange value of the dollar, rather than responding to demand and output growth in the domestic economy, could become the paramount factor in setting monetary policy. Policies designed to address pressures on the dollar abroad could mean rising interest rates, with severe consequences for the domestic economy.

This Report provides a review of both the short-term and the long-term outlook for the U.S. economy. It explores a number of problems which have developed below the surface of our economy, and the changes in the world economy in which the United States must compete. Facing these challenges realistically is essential to the future health of our economy, on which our national strength both at home and abroad inevitably depends.

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THE 1987 JOINT ECONOMIC REPORT

MARCH 5, 1987.—Ordered to be printed

Filed, under authority of the order of the Senate of March 3, 1987

Mr. SARBANES, from the Joint Economic Committee,
submitted the following

REPORT

together with

MINORITY, ADDITIONAL, AND DISSENTING VIEWS

69–874

I. ECONOMIC PERFORMANCE AND PROSPECTS

A. THE RECENT PAST

Many of the economic challenges that face the Nation in the years ahead have their roots in the policies and performance of the recent past. This chapter reviews the performance of the American economy during the 1980's and then examines the short-term and long-term prospects.

RECENT ECONOMIC PERFORMANCE: THE RECESSION AND RECOVERY

The economic performance of the 1980's has been dominated by the severe recession of 1981-1982 and the ensuing recovery. The recession was the worst since the Great Depression,1/ and has left a legacy of relatively high unemployment, substantial excess capacity, and sharp regional and sectoral disparities which continue despite the subsequent recovery.

The recovery since the depth of the recession in 1982 has been brought about by substantial fiscal stimulus from the Federal deficit and a dramatic turnaround in monetary policy. Yet despite these strong pressures toward economic expansion, overall economic growth for the past 18 months has been "relatively sluggish," according to the latest Council of Economic Advisers'(CEA) Report.

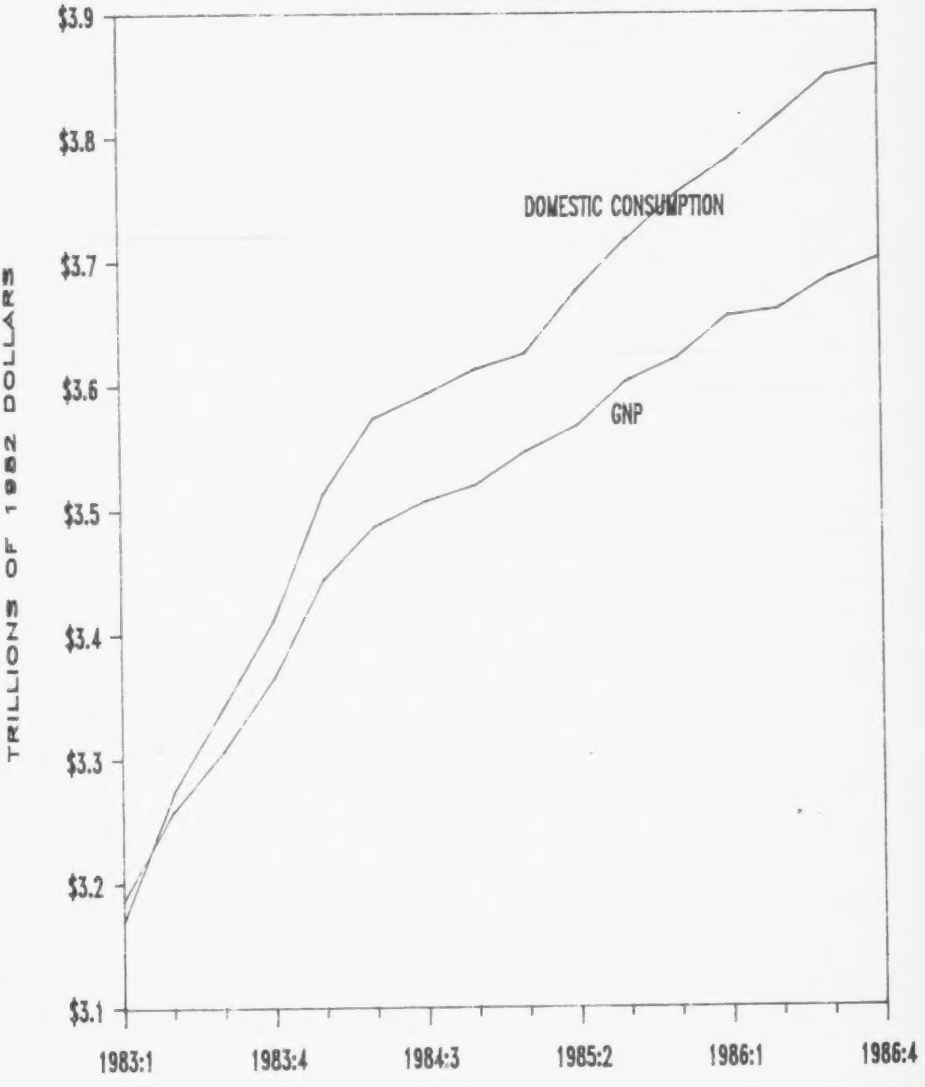
The same conclusion does not hold with respect to consumption. Domestic demand expanded at a brisk 3.6 percent pace during 1986, but much of this demand was filled by imports, and domestic production rose only 2.5 percent. Present economic policies appear to have produced an increase in consumption which is not matched by a similar increase in production, and it is the divergence of these trends which provides the strongest indication of the fragility of the current recovery.

1/ The civilian unemployment rate exceeded 10 percent from September 1982 through June 1983 for the first time since 1940, and peaked at 10.7 percent in November 1982.

CHART I

PRODUCTION AND CONSUMPTION

IN THE AMERICAN ECONOMY



Production

Gross National Product (GNP)

While consumption was growing a healthy 3.6 percent in 1986, production, as measured by GNP, rose only a weak 2.5 percent. This was below the sluggish 2.7 percent growth registered in 1985 and only marginally above the average annual growth rate of 2.4 percent for 1981-1985. By comparison, real growth averaged 2.8 percent in the 1970's and 3.5 percent between 1950 and 1980.

It should be pointed out that the average for the 1980's is distorted by the extraordinarily strong growth performance of the economy in 1984. As Table I shows, the 6.4 percent real growth of that year was the strongest of any year since 1951, but this has proved to be a one-time event with other recent years far off the course.

TABLE I

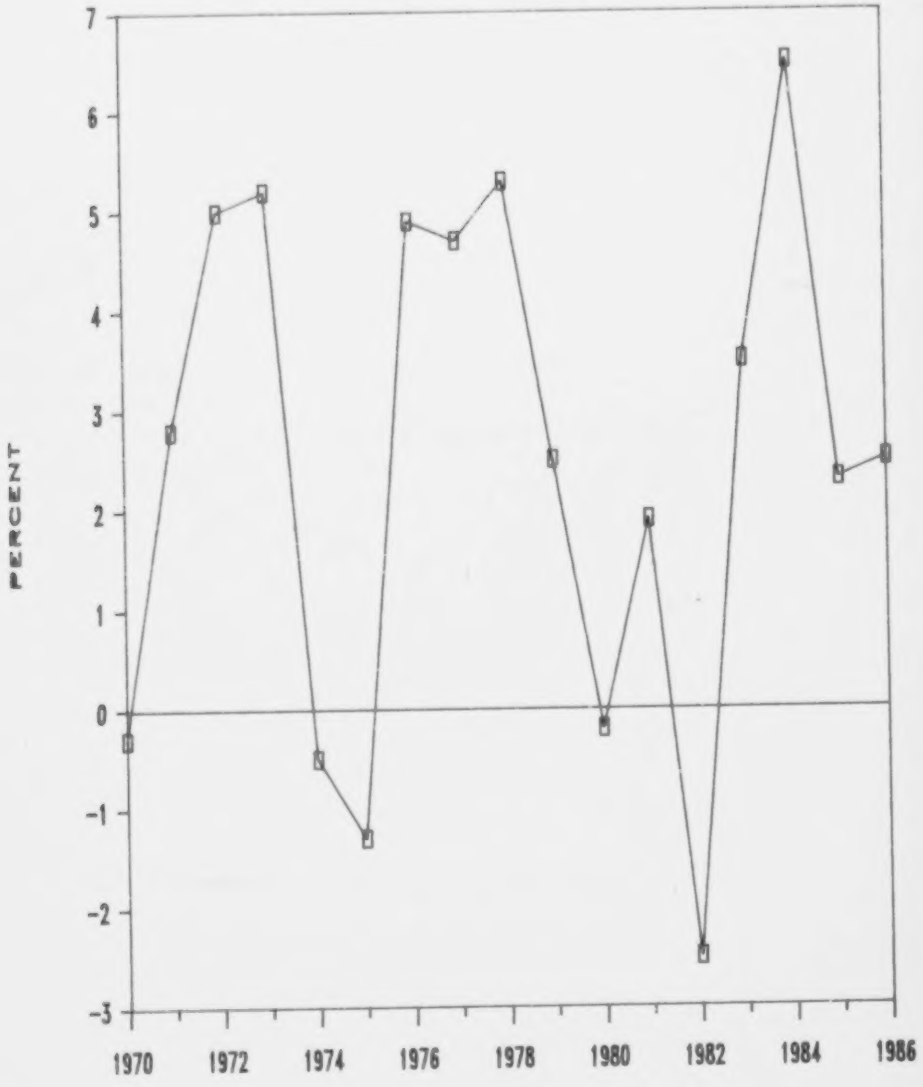
REAL GNP GROWTH

1980 -- -0.2%
1981 -- 1.9
1982 -- -2.5
1983 -- 3.6
1984 -- 6.4
1985 -- 2.7
1986 -- 2.5

Industrial production, the key index of output growth in the manufacturing sector, rose only 1 percent for 1986, only half the rate of the previous year and only one-quarter of the average annual growth rate which prevailed in the 1970's.

CHART II

GNP GROWTH RATE



Productivity

A principal reason for sluggish output growth in a number of sectors is slow productivity growth. Increases in productivity have accounted for 71 percent of the total increase in output in the American economy between 1947 and 1965, but fell to 50 percent between 1965 and 1973, and dropped again to 29 percent between 1973 and 1986. With this slow productivity growth, the expansion of output in the economy is excessively dependent on expansion of the labor force, and the rate of labor force growth is projected to slow considerably in the years ahead. The most recent productivity statistics provide little encouraging news. Productivity growth in the nonfarm business sector rose only 0.5 percent in 1985 and 0.7 percent in 1986. In the fourth quarter of 1986, nonfarm productivity actually fell 1.7 percent.

A significant portion of this overall decline in productivity growth is accounted for by the shift toward services in the employment and output mix of the economy. As Federal Reserve Chairman Paul Volcker told the Committee on February 2:

> One of the problems in the inflation area is [that]...in the services area productivity growth is zilch, basically, if one believes the figures.

Employment and Unemployment

Because of the relatively slow growth in production, employment growth has been constrained and unemployment remains high. Civilian employment rose 2.4 million in 1986. While this was above the 1.7 million average annual increase in employment registered between 1980 and 1985, it was barely enough to keep pace with the year's labor force growth, and it is far below the annual rate of job growth of four million which prevailed in 1978. After rising to a post-Depression high of 10.7 percent in November 1982, the unemployment rate has declined gradually, averaging 7.0 percent in 1986, compared to 7.1 percent in 1985. The number of people unemployed declined only marginally from 8.3 million in 1985 to 8.2 million in 1986. Between 1980 and 1986, the unemployment rate fell only 0.1 percent, from 7.1 percent to 7.0 percent, while the average number of people unemployed actually rose by 600,000.

Recent experience confirms the secular upward trend in unemployment which is demonstrated in Chart V. Each recession drives the unemployment rate to new heights, and each recovery tops out with a higher rate of unemployment than its predecessor.

CHART III

PRODUCTIVITY GROWTH

(Non-Farm Business)

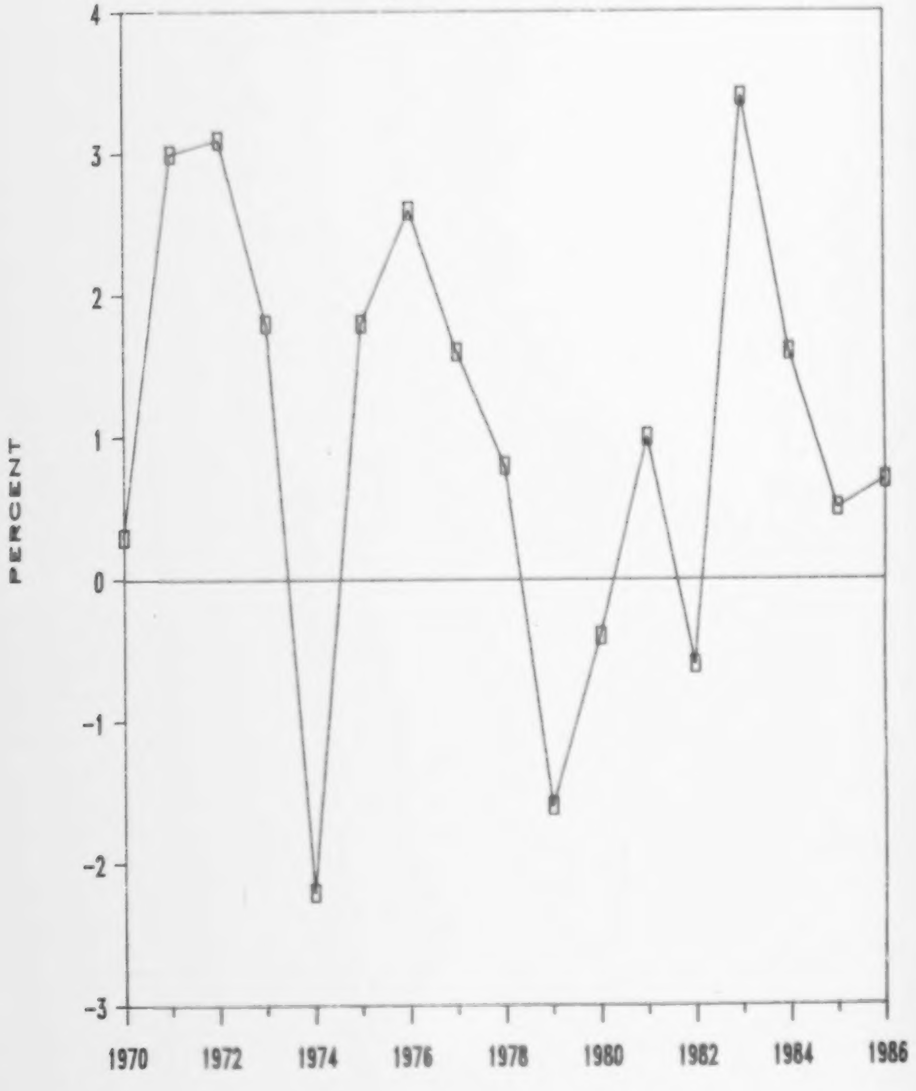


CHART IV

EMPLOYMENT GROWTH

All Jobs

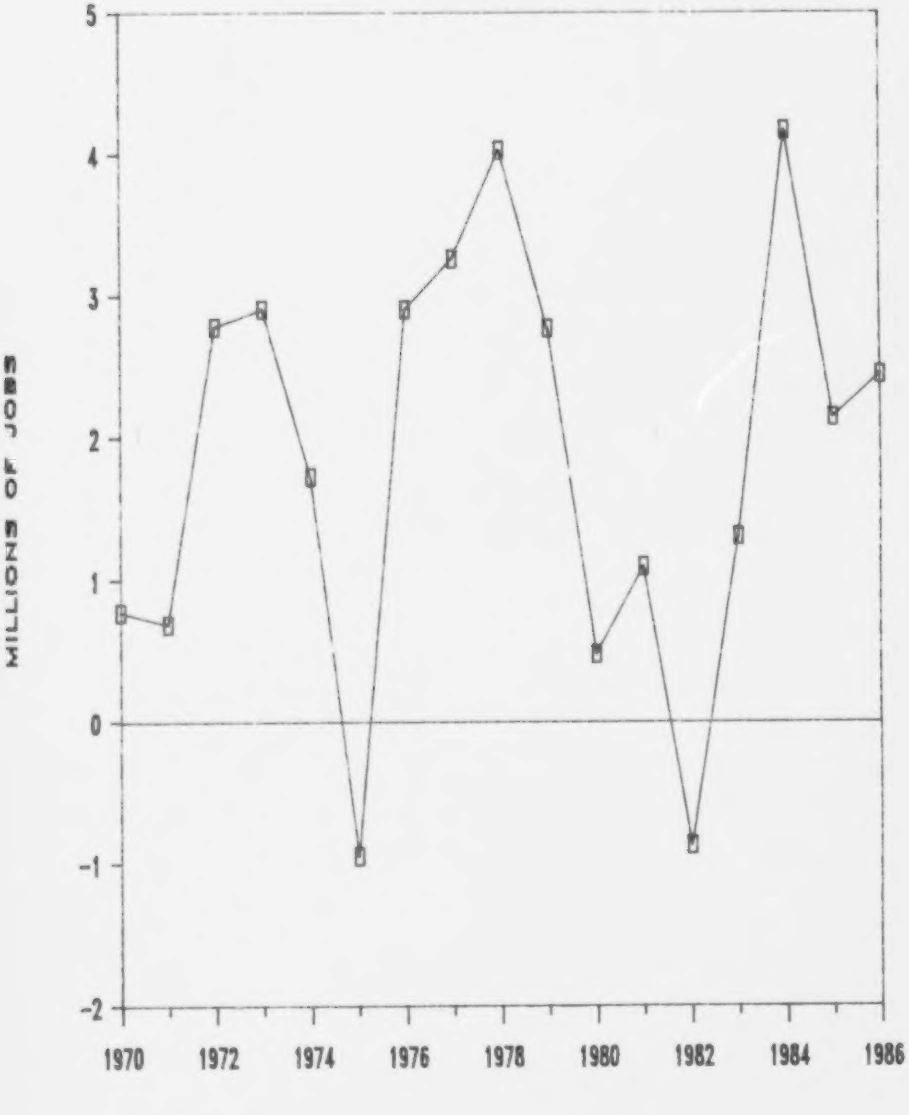
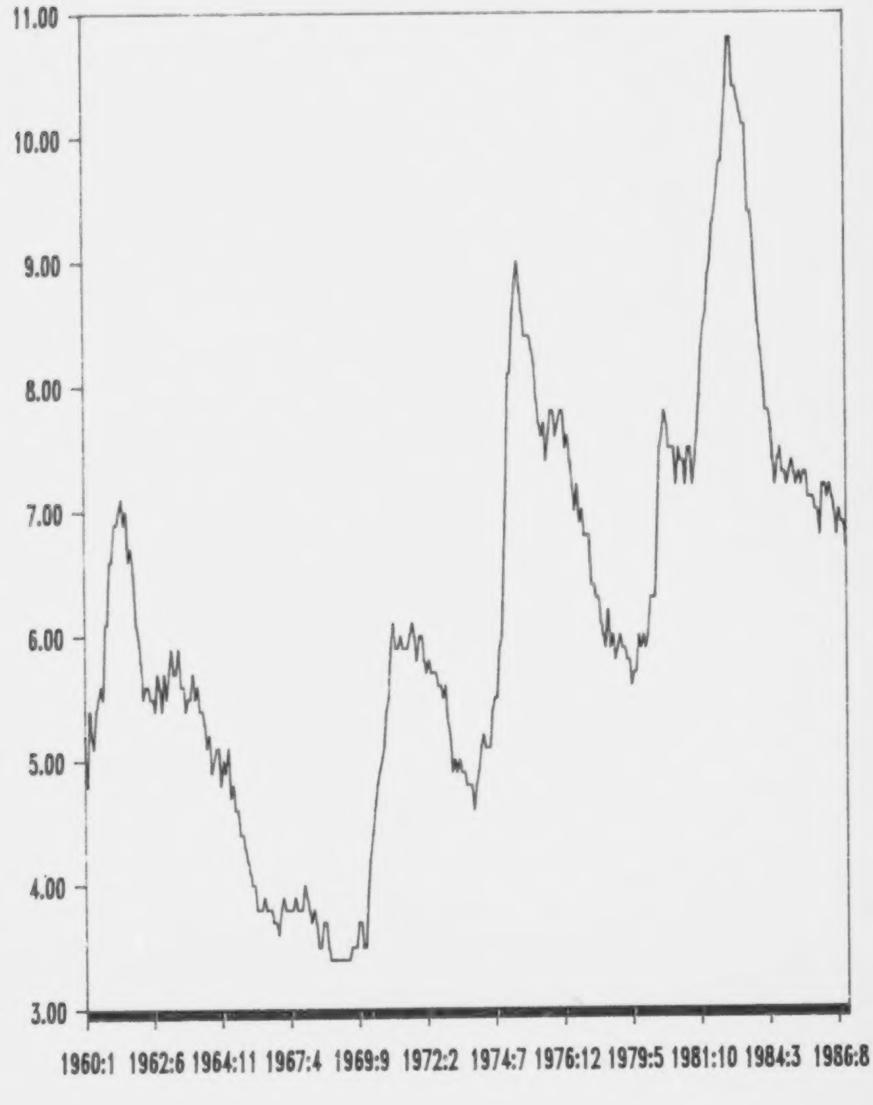


CHART V

CIVILIAN UNEMPLOYMENT RATE



There is also evidence that the structure of employment is changing in ways which may not be positive for the long-run growth in earnings and productivity in the American economy. Since the economy reached its last peak in July 1981, more than a million manufacturing jobs have been permanently lost. Job creation has been in lower skilled, lower paying service-sector jobs, many of which are without such traditional benefits as health insurance or pension rights.

In addition to these sectoral shifts, there remains a very high level of Americans who are forced to accept part-time work because full-time work is not available. The number of discouraged workers -- those who wish to work but are not actively looking because jobs are not available -- is also very high, averaging more than 1.1 million in 1986. Blacks, who make up 12 percent of the labor force, constitute 26 percent of discouraged workers.

Wages, Incomes, and Poverty

With persisting high unemployment, substantial rates of involuntary part-time work, and a shift to lower paying service jobs, overall growth in wages and family incomes has been extremely modest over the past several years.

The income picture for most traditional blue-collar workers is shown best by the Labor Department's series on average weekly earnings for non-supervisory production workers. As Chart VIII illustrates, real weekly earnings have fallen substantially since the early 1970's, and rose only 0.4 percent in 1986. This weak growth leaves the figures no higher than they were in 1980.

Figures on hourly compensation portray a similar picture of stagnant growth in the real returns to work in the American economy. The Labor Department's index of real compensation per hour has remained virtually stagnant since the early 1970's, following a 20-year period of steady upward movement.

CHART VI

EMPLOYMENT GROWTH

MANUFACTURING AND SERVICE SECTORS

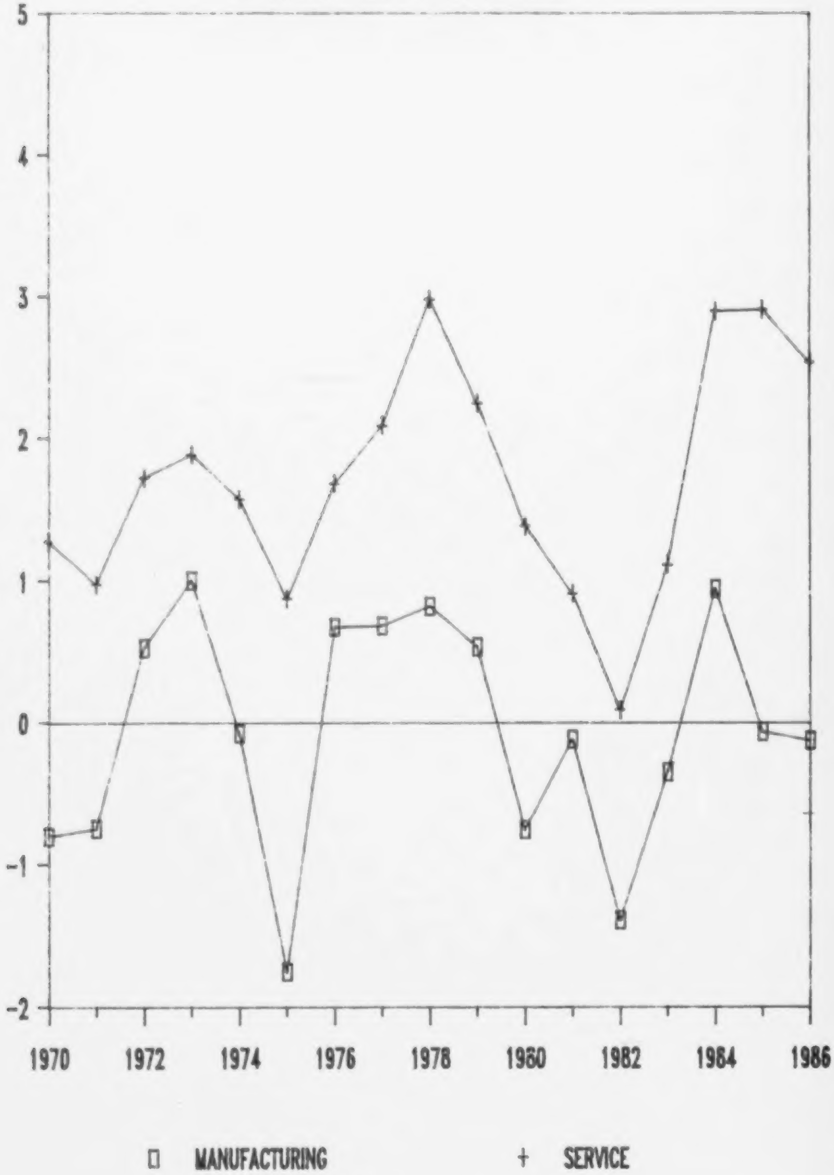


CHART VII

WORKING PART-TIME FOR ECONOMIC REASONS

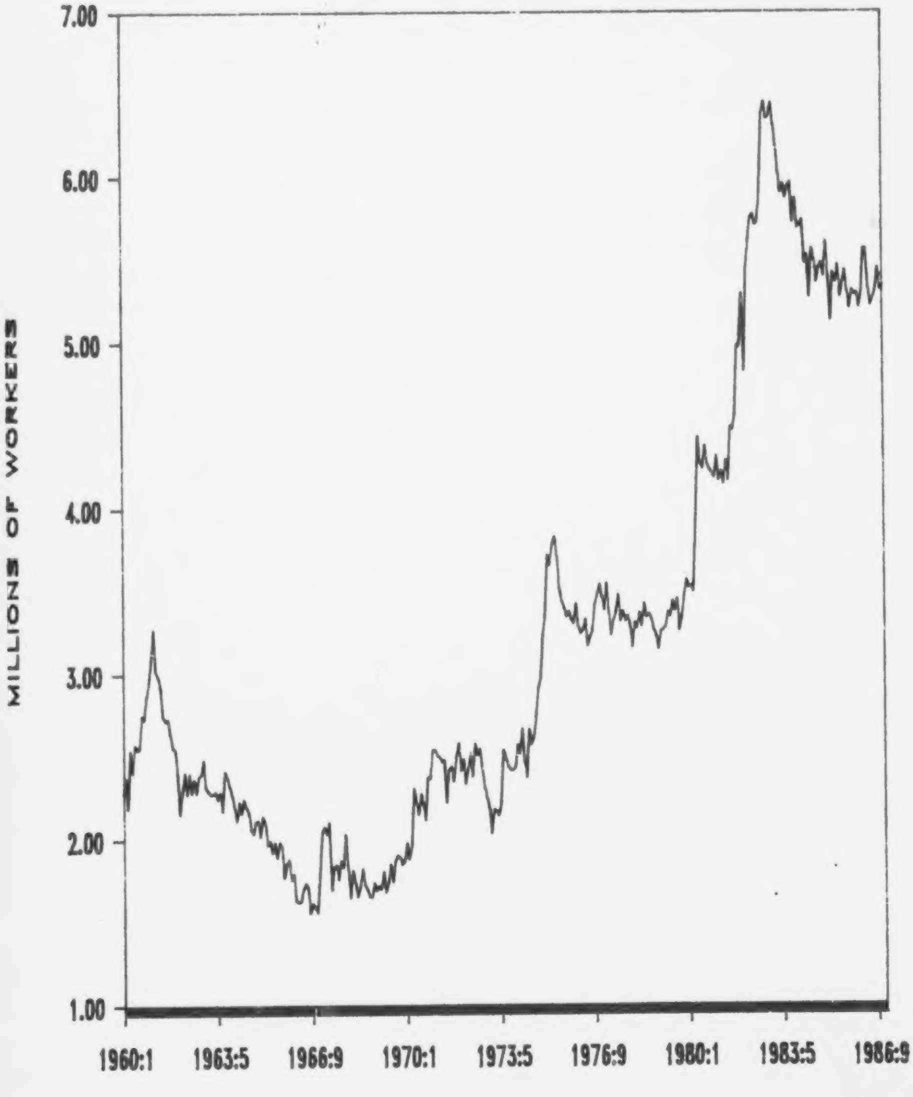


CHART VIII

AVERAGE REAL WEEKLY EARNINGS

(Private Non-Farm Industries)

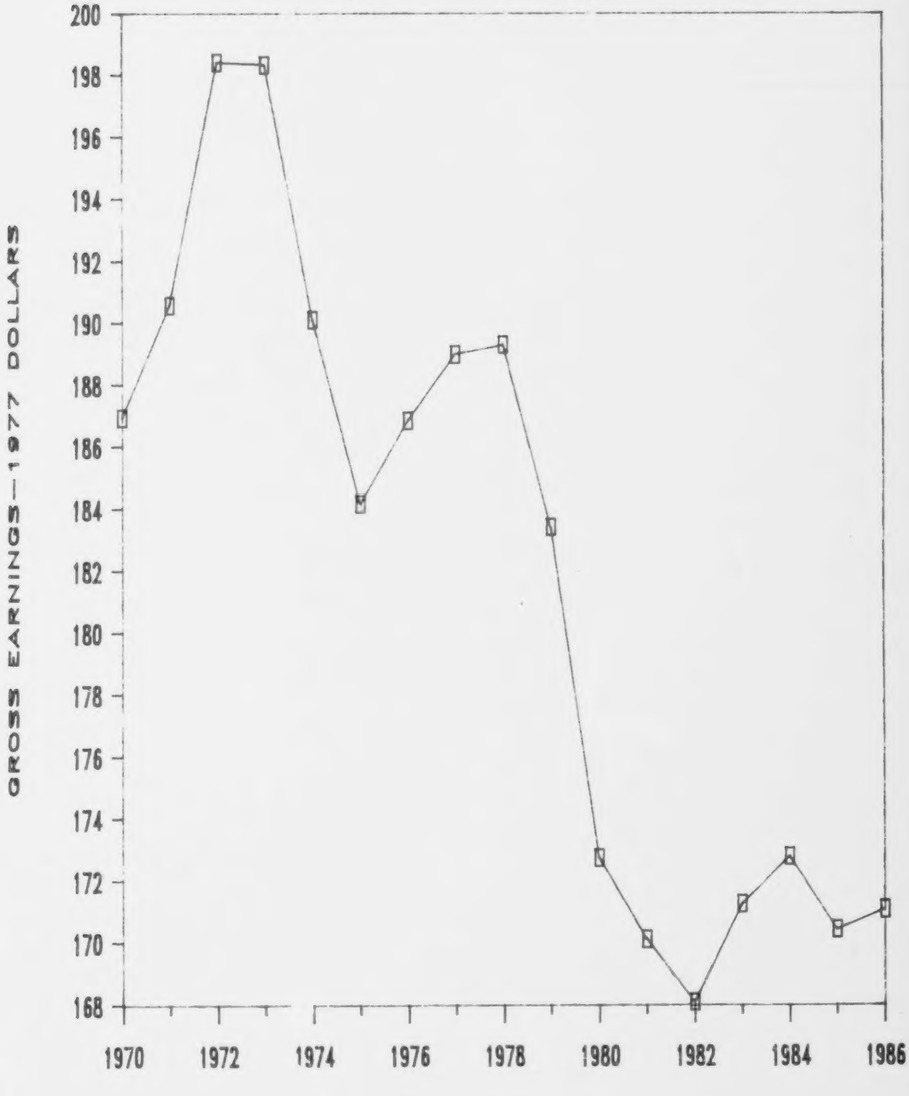
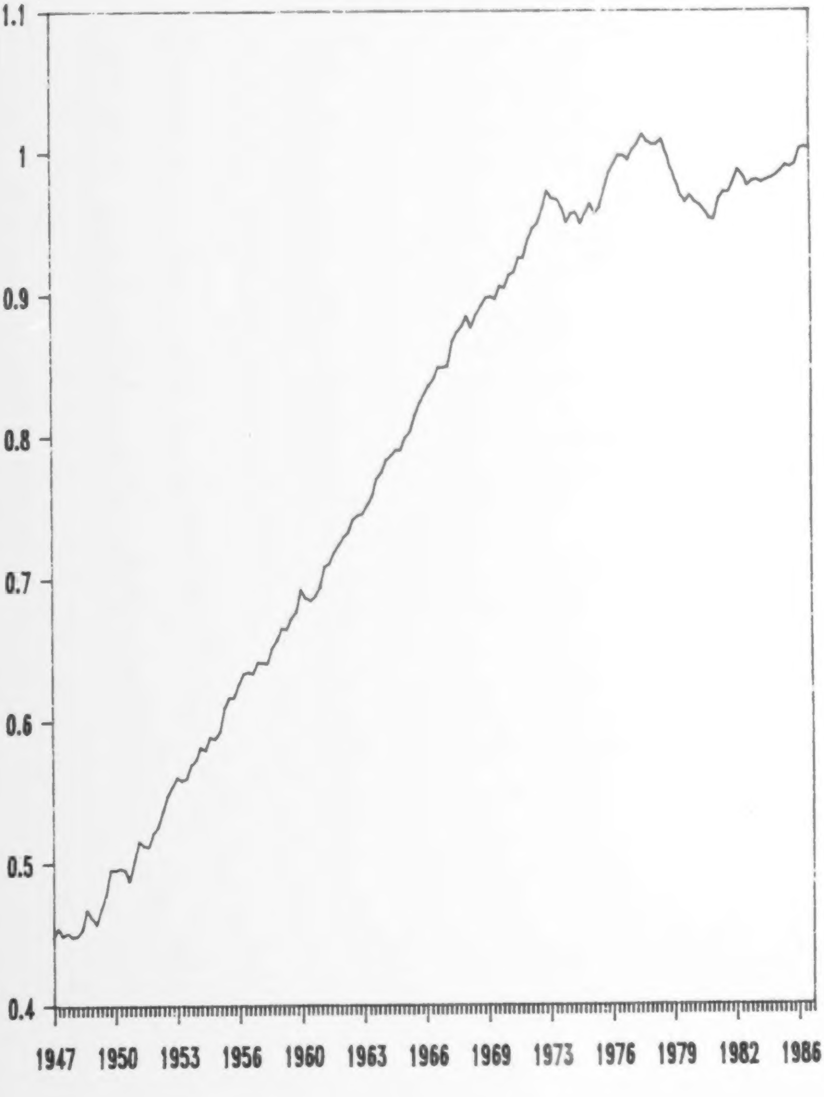


CHART IX

REAL COMPENSATION PER HOUR

INDEX: 1979=1.00



American workers and families have responded to this stagnation in hourly earnings in a number of different ways in an effort to maintain income growth in a period of slow wage increases. Labor force participation rates have risen, especially for women, and more and more families are required to have two earners just to meet the budget. As a result of this shift, real per capita disposable income has risen significantly since the depth of the 1981-1982 recession, but this increase has not been sufficient to bring real per capita disposable income up to the level it would have achieved if the trend growth of 1946 to 1980 had been maintained (see Chart X). More disturbing is the fact that real disposable income per capita fell in both of the final two quarters of 1986.

Taken together, these trends have combined to produce a pattern of virtual stagnation in real median family income, perhaps the best indicator of both the level and distribution of the American standard of living. As Chart XI suggests, real median family income has hardly grown since the late 1960's, and is well below the growth path established during the 1946-1974 period. The recent rise in this statistic reflects the overall recovery from the 1981-1982 recession, but has not been strong enough to raise median family income above its 1979 level.

Those at the bottom of the economic ladder have borne much of the burden of slow income growth and high unemployment. The Census Bureau's index of income concentration shows the greatest degree of inequality since 1947, and the 1985 poverty rate was 14 percent. While this was an improvement from the 15.2 percent poverty rate of 1983, it was a full 20 percent higher than the rate in 1979. The number of persons living in poverty increased from 19.7 million in 1980 to 22.9 million in 1985. The most recent recovery has done less than previous recoveries in reducing the poverty rate.

Geographic Disparities in Economic Growth

There have been significant geographic disparities in economic growth during the 1980's. As Chart XII shows, the unemployment rate varies substantially across the Nation.

Inflation

The inflation picture is a brighter spot in the economic scene. In 1986, the Consumer Price Index (CPI) rose 1.1 percent, the smallest increase in 25 years. Most of the improvement, however, was due to a collapse of oil prices and the downward pressure put on prices by imports generally.

CHART X

REAL PER CAPITA DISPOSABLE INCOME

ACTUAL VS. 1946-80 TREND

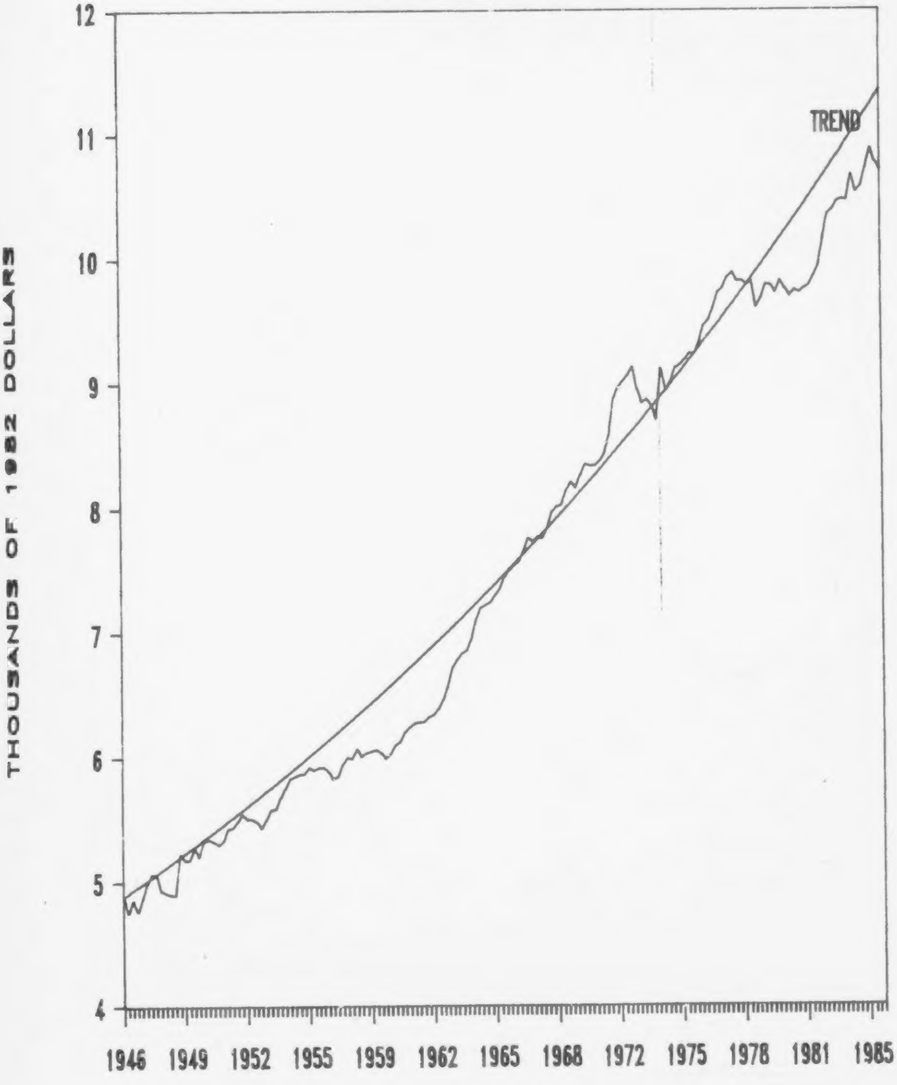


CHART XI

REAL MEDIAN FAMILY INCOME

ACTUAL VS. 1946-74 TREND

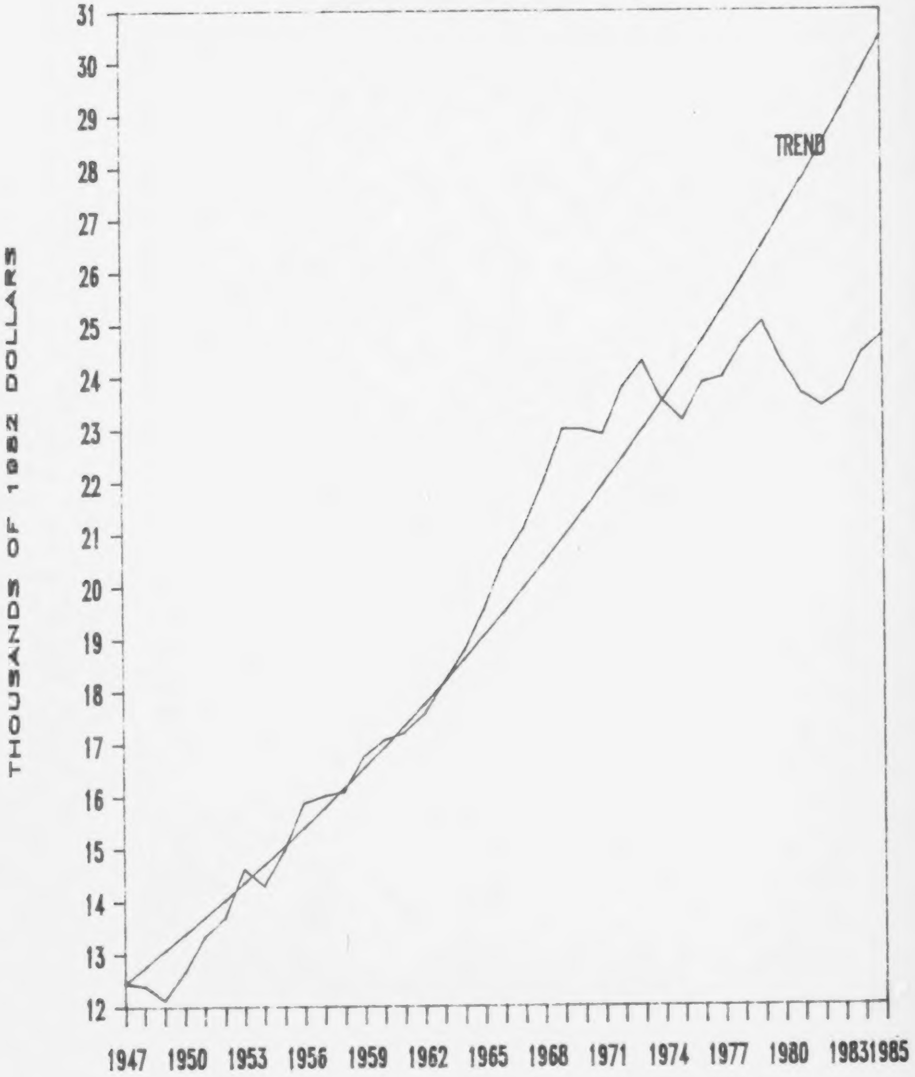


CHART XII

1986 UNEMPLOYMENT RATES BY AREA

U.S. Census Regional Divisions

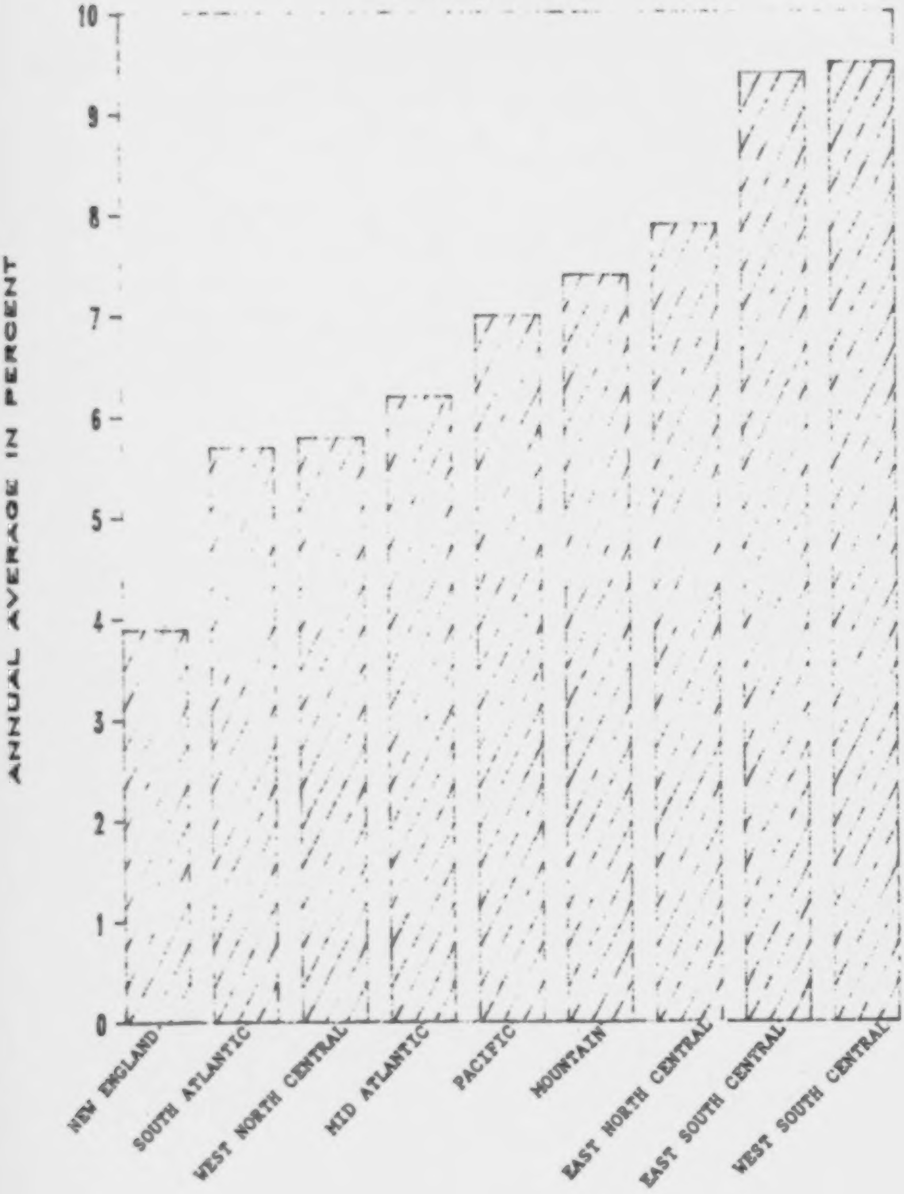


Chart XIII tracks inflation in a number of key areas, and Chart XIV suggests that the CPI presents an unusually optimistic picture of inflation. Excluding the oil price decline, consumer prices rose 3.8 percent in 1986, precisely in line with the 3.9 percent inflation rate of 1982-1985. This was below the high inflation rates of the late 1970's, but still well above the inflation that characterized most of the 1960's.

Price inflation in key sectors, particularly the service sector, remains a persistent problem. While prices rose a modest 1.8 percent in the durable goods sector and actually fell by nearly 2 percent in the nondurable goods sector, the cost of legal services rose 8 percent, medical services over 4 percent, and the housing cost index by 5.4 percent. Overall, inflation in the services averaged 4 percent last year, an improvement over the late 1970's but still not as low a value as the CPI alone would suggest.

These numbers suggest that inflationary tendencies remain in the American economy, and that the next external price shock could lead to a revival of overall inflation.

Money Supply and Interest Rates

Very rapid growth in the money supply, which has been a key element in stimulating the economy for the past several years, continued in 1986. M1 grew at 16.9 percent for 1986, and M2 grew at 9.1 percent, rates substantially higher than that of growth in nominal GNP. M1 growth was well in excess of the Federal Reserve's target, helping to raise concerns in the financial markets about the future inflationary consequences of recent rapid money growth.

Largely as a result of rapid growth in the money supply, nominal interest rates have fallen significantly during the past year. As the CEA Report notes, however, real interest rates remain at historically high levels. These high real interest rates are an important obstacle to renewed capital investment.

CHART XIII

INFLATION RATES BY SECTOR—1986

(CONSUMPTION DEFLATORS)

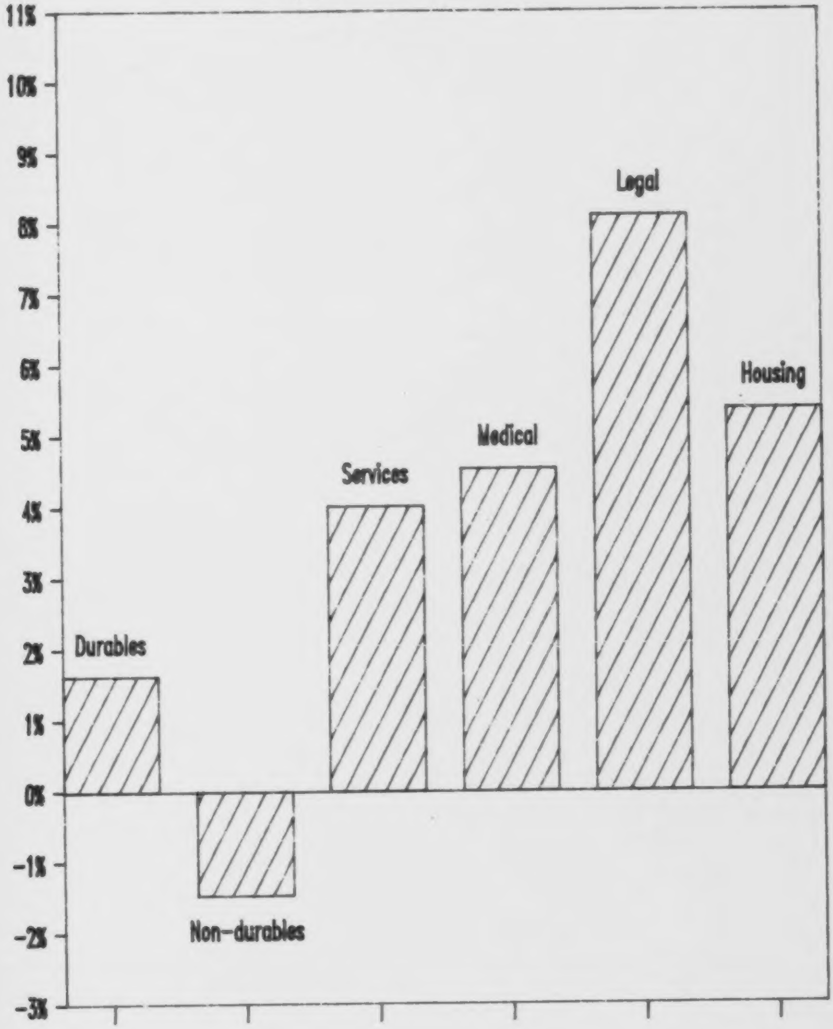


CHART XIV

INFLATION RATE

All Items Except Energy

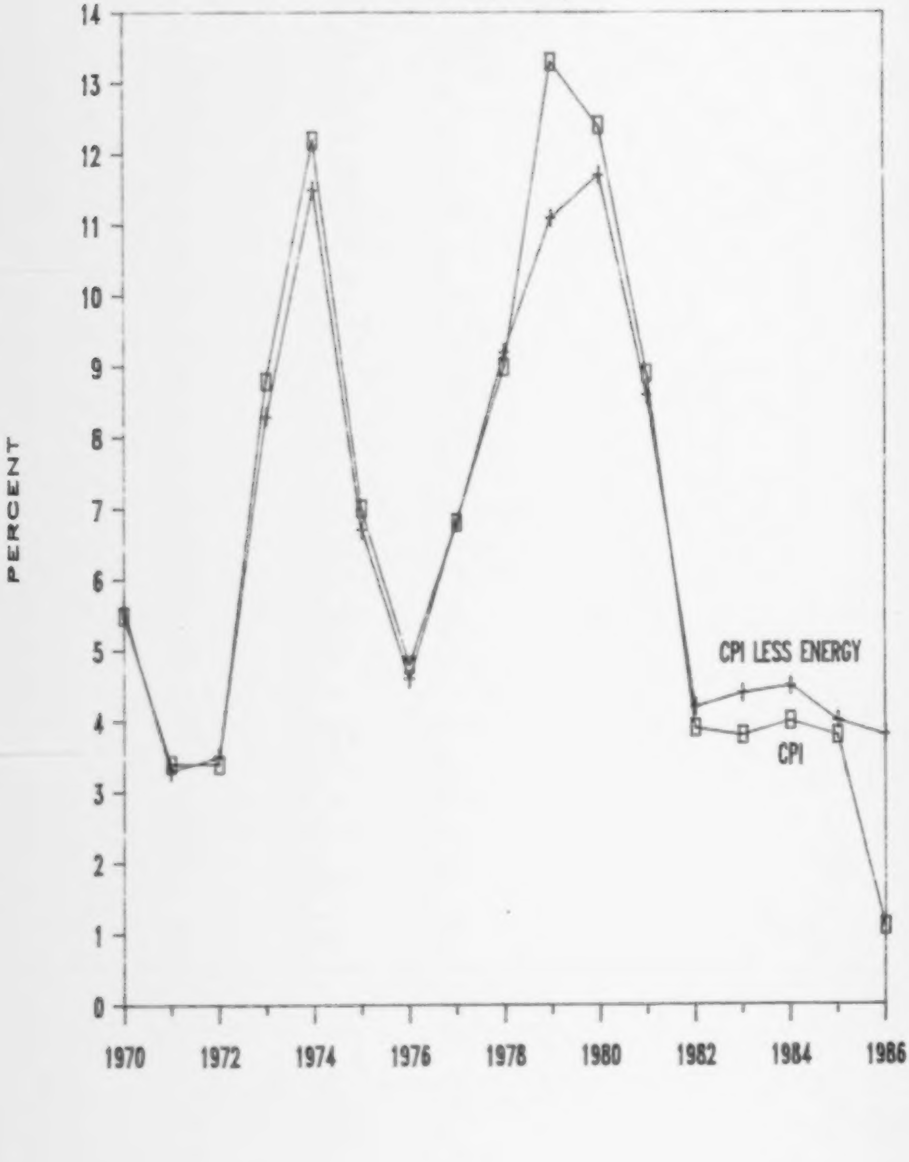


CHART XV

RATE OF MONEY GROWTH

(PERCENT CHANGE IN M-1)

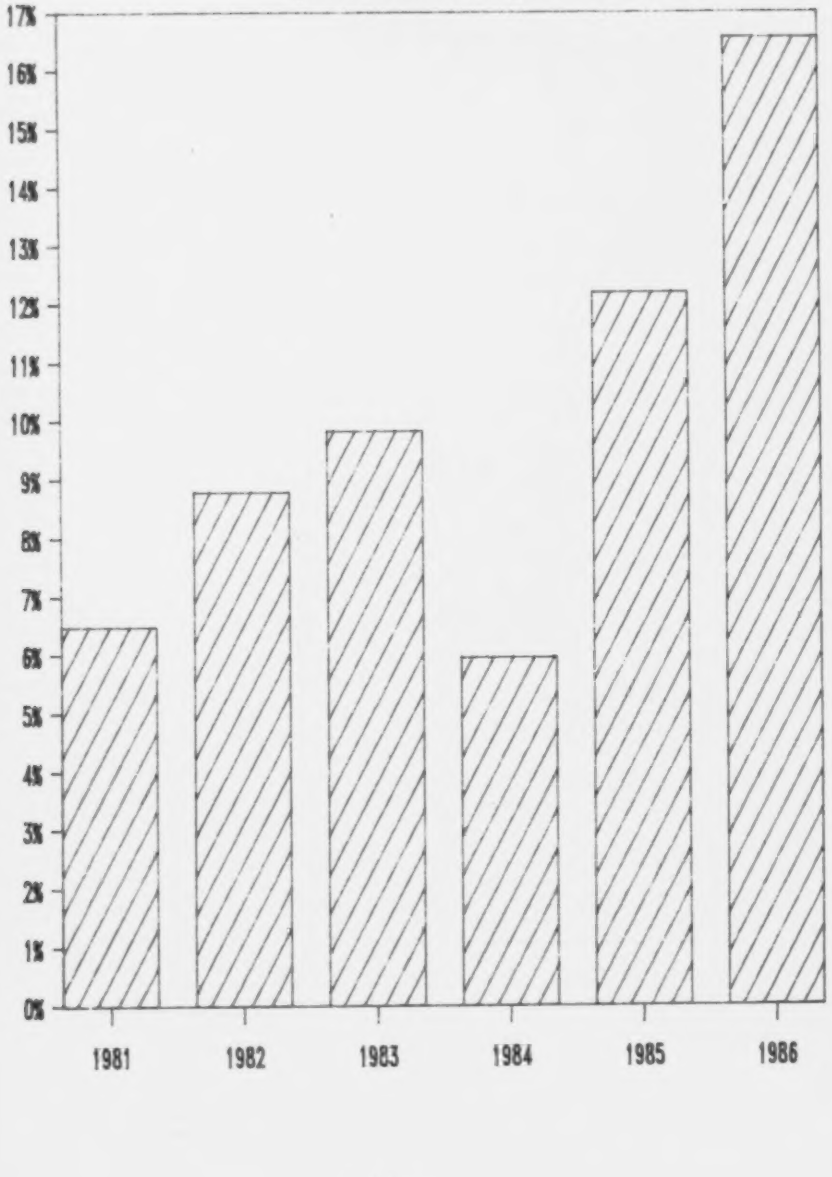
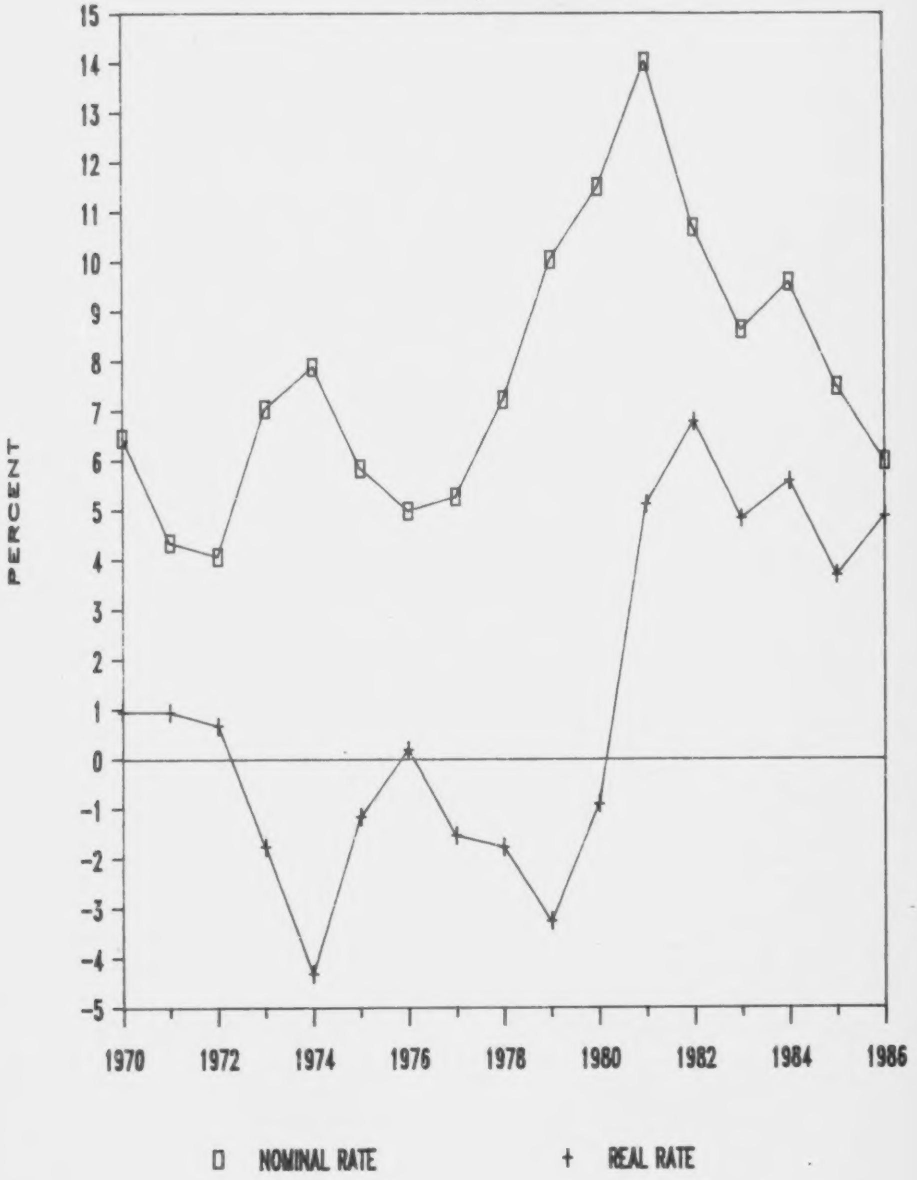


CHART XVI

NOMINAL AND REAL INTEREST RATES

Treasury Bills



Investment, Profits, and Capacity Utilization

Investment in plant and equipment, which had risen strongly in the two previous years, fell in 1986. This development raises considerable concern about the future growth rate of the economy. High real interest rates played a role in depressing investment, as did the high level of idle capacity in the industrial sector and depressed corporate profitability.

Consumption

The strong growth in domestic demand was largely produced by a very substantial reliance on debt. Firms, households, and government all borrowed heavily during 1986, sustaining consumption but at the price of accumulating large obligations which must be serviced out of future earnings.

The Federal Deficit

In Fiscal Year (FY) 1986, the Federal deficit was $220.7 billion, the largest ever recorded. The 1981 tax cut, combined with an increase in defense spending, more than compensated for reductions in spending on domestic programs, stimulating the economy and raising the deficit to more than 5 percent of GNP for the first time in the postwar period. This on top of similar large deficits throughout the 1980's brought the national debt to $2.1 trillion by the end of FY 1986. Between 1980 and 1986, the national debt more than doubled from $0.9 trillion to $2.1 trillion.

Household Debt

Households also took on record amounts of debt in 1986, with the ratio of consumer installment debt to disposable income rising to 21 percent, the highest level on record. This was accompanied by a fall in the household savings rate to 3.9 percent, the lowest level in 40 years. Any attempt by households to reduce some of their debt burden could have a major chilling effect on domestic demand in the economy.

CHART XVII

NEW PLANT AND EQUIPMENT

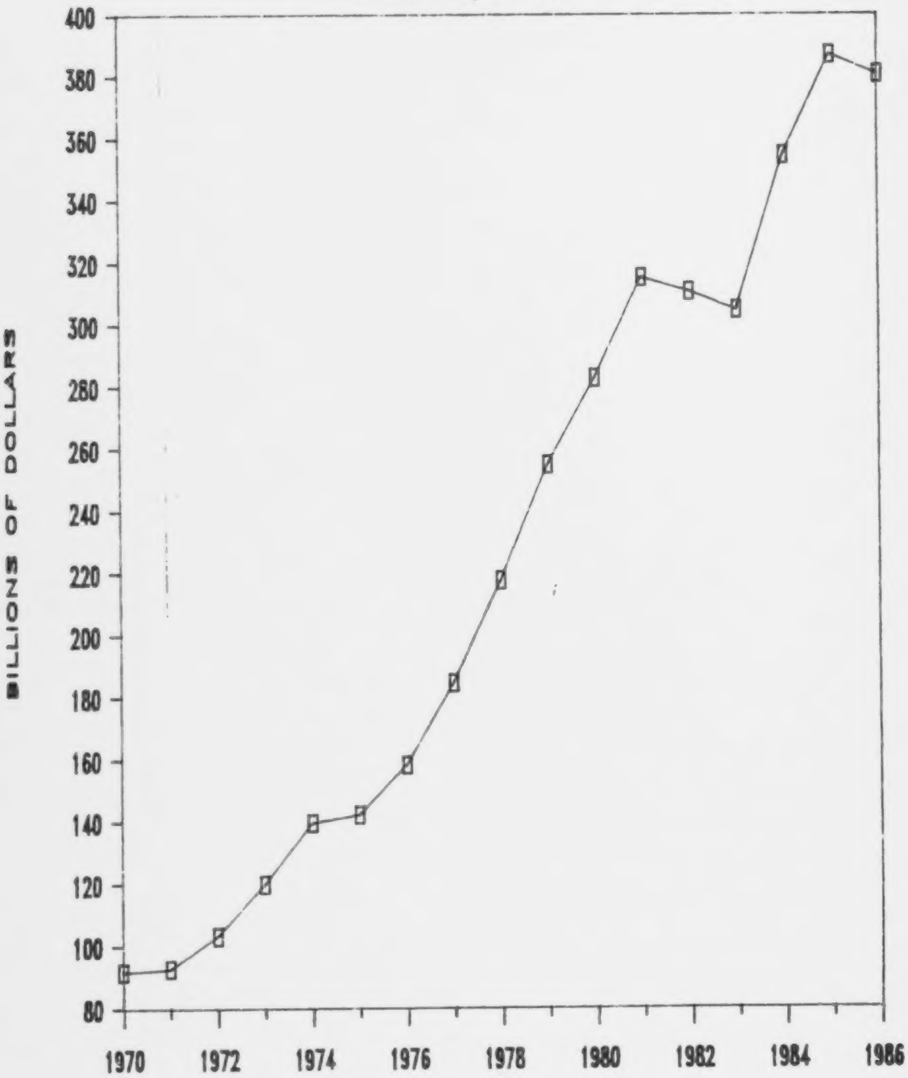


CHART XVIII

AFTER TAX CORPORATE PROFITS

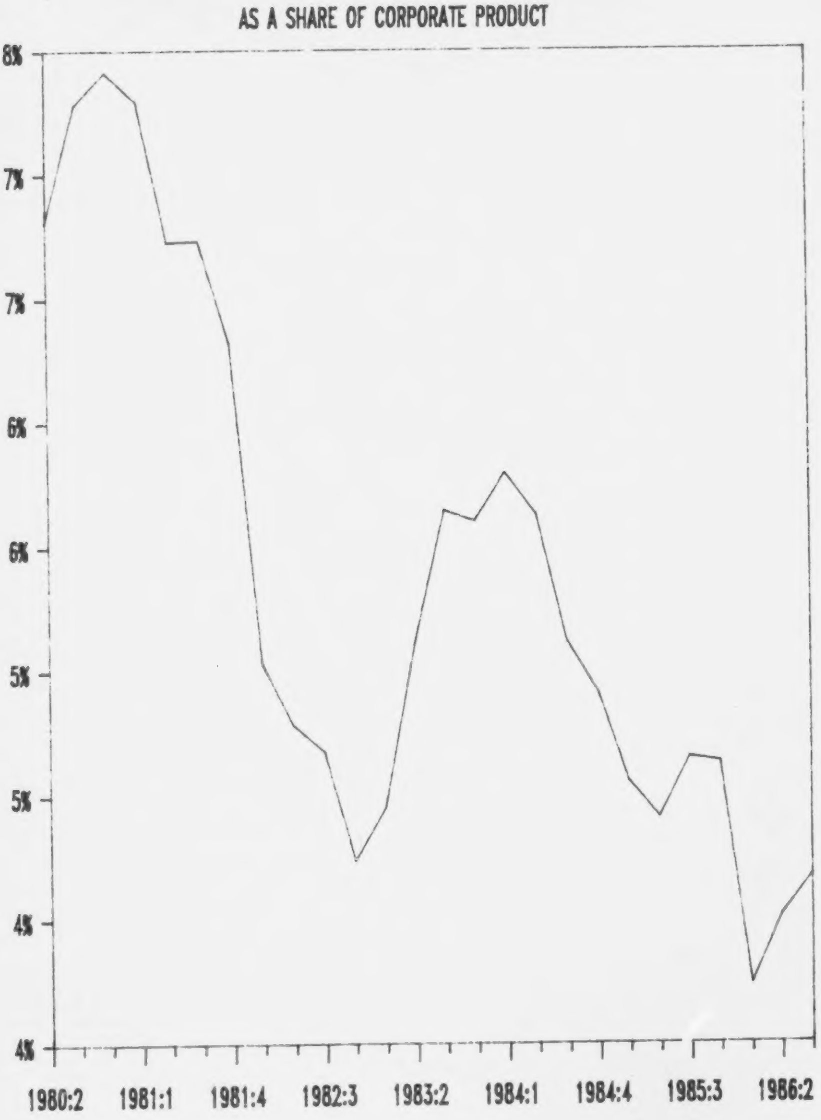


CHART XIX

CAPACITY UTILIZATION RATES

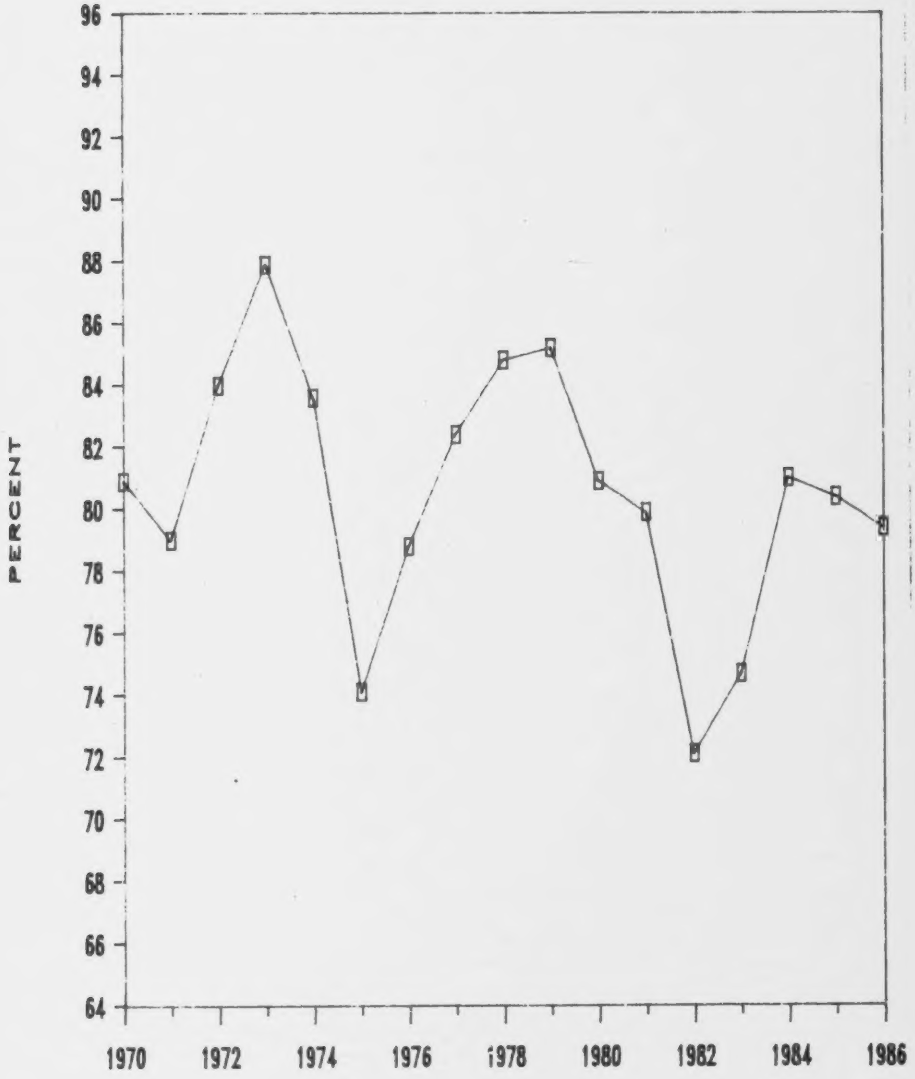


CHART XX

THE FEDERAL DEFICIT

(Fiscal Years)

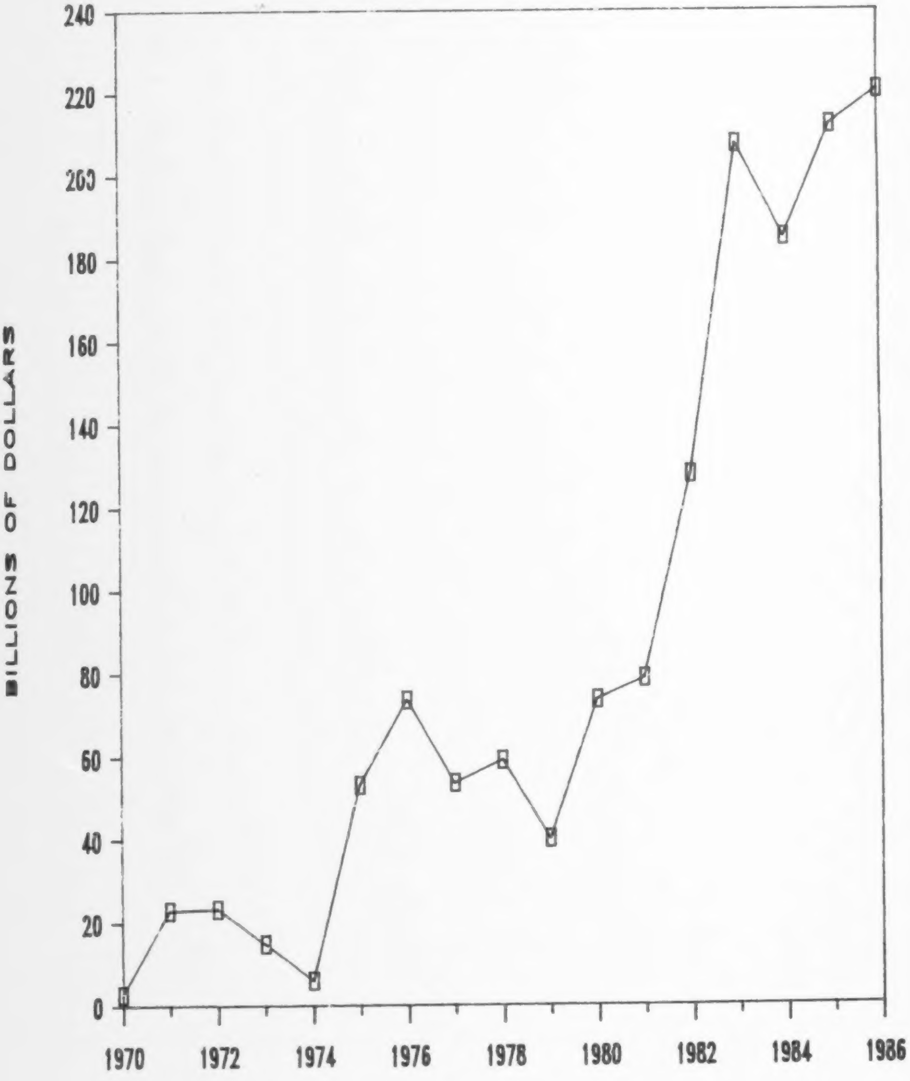


CHART XXI

THE NATIONAL DEBT

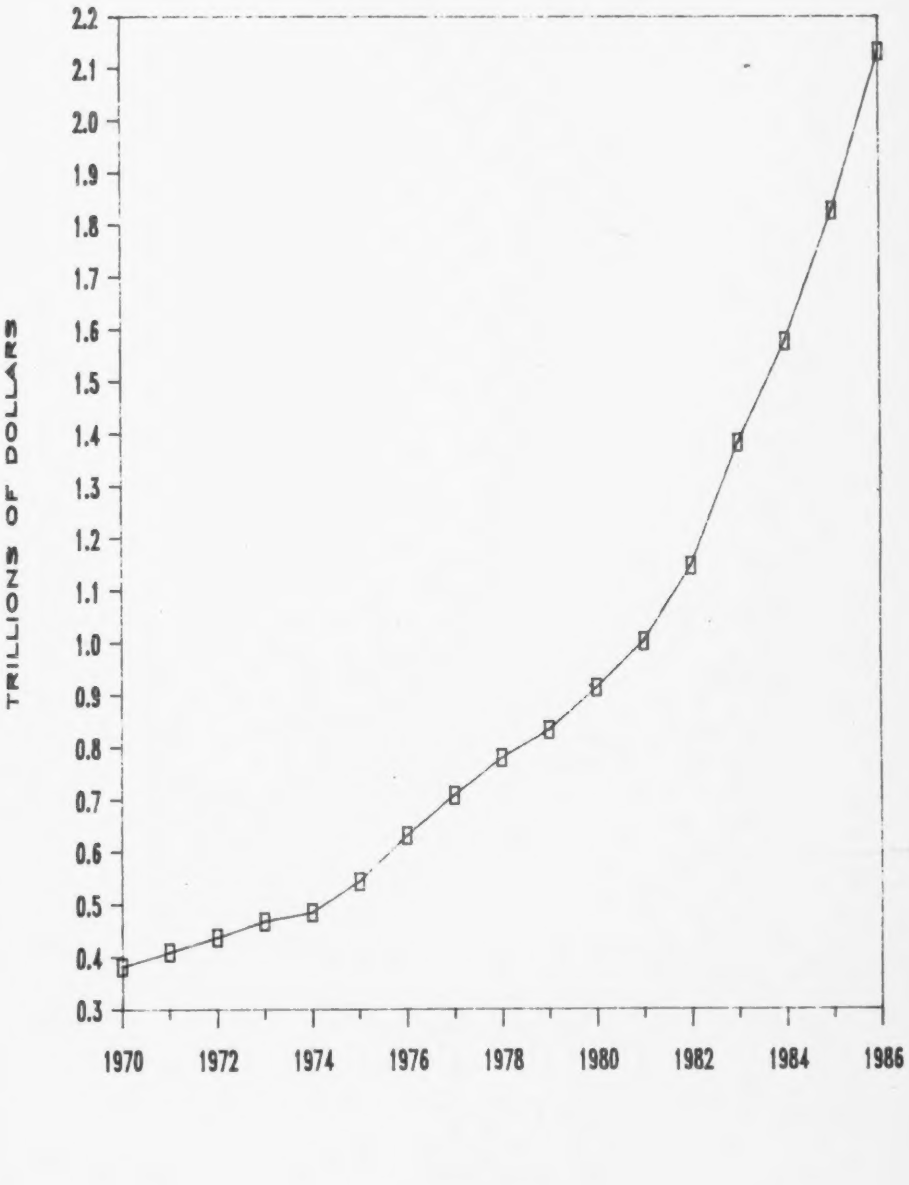
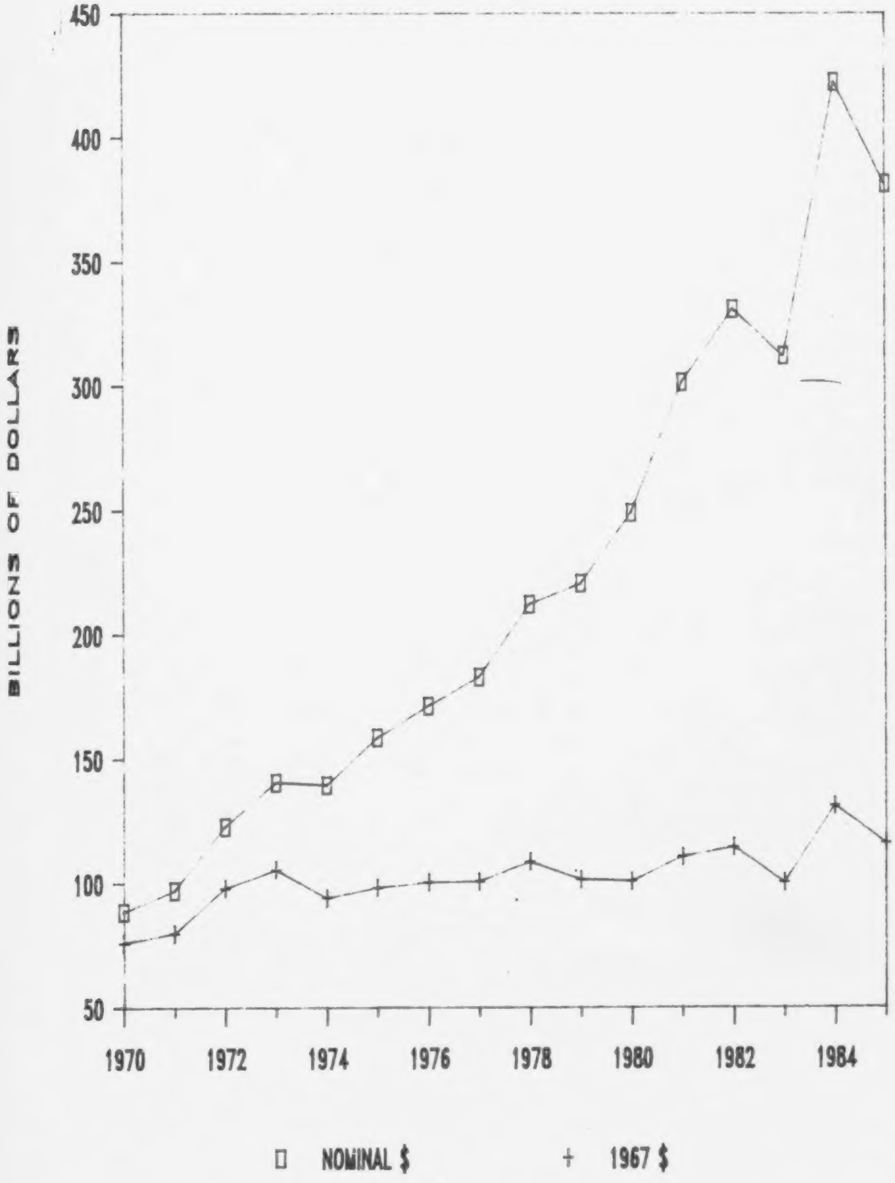


CHART XXII

SAVINGS BY INDIVIDUALS



Corporate Debt

Corporations significantly increased their borrowing during the year, using much of the new funds obtained to engage in mergers and acquisitions. Debt was used in record amounts to retire equity, shifting the balance sheet of the corporate sector sharply toward debt finance. Since debt must be repaid no matter what a firm earns, while equity rides out the ups and downs of corporate fortune, the increasing importance of debt on corporate balance sheets raises serious concerns about the ability of many in the corporate sector to weather any future recession.

International Deficits and Debt

The country as a whole also took on a vast amount of new debt last year in the form of foreign borrowings needed to finance the huge U.S. current account deficit. The merchandise trade deficit continued to deteriorate in 1986, reaching $170 billion compared to $148 billion in 1985. The trade deficit now amounts to over 4 percent of GNP, the worst record in our history. Despite the decline in the dollar that began in February 1985, a turnaround in the deficit is not yet in sight. For all of 1986, imports rose $26 billion while U.S. exports rose only $4 billion.

The sharp growth in the merchandise trade deficit has been associated with vast capital imports from abroad. The result has been a sharp reversal in the U.S. international asset position, from the world's largest creditor in 1981 to the world's largest debtor in 1986. The United States has reversed all precedent and, instead of filling an advanced nation's traditional role of supplying capital to the rest of the world, has been borrowing savings from the rest of the world at an unprecedented rate.

CHART XXIII

THE TRADE DEFICIT

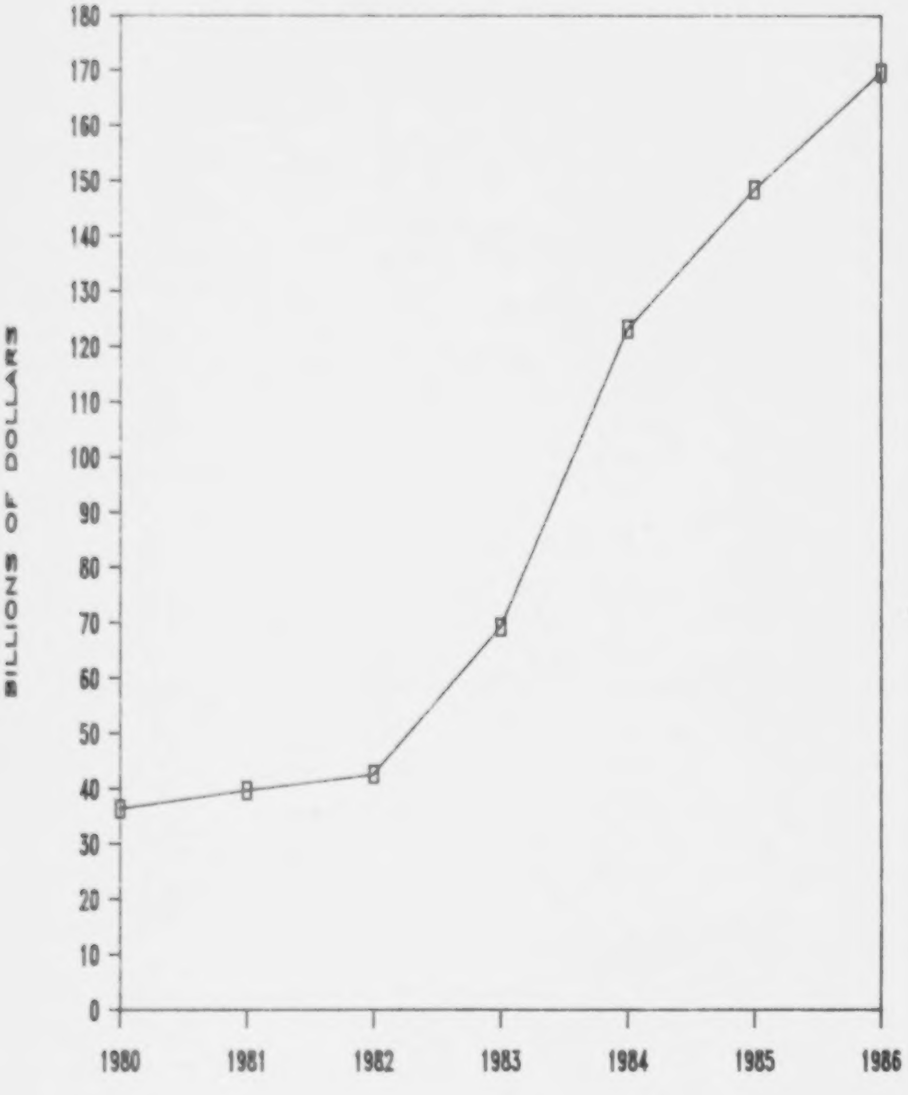


CHART XXIV

TRADE DEFICIT AS PERCENTAGE OF GNP

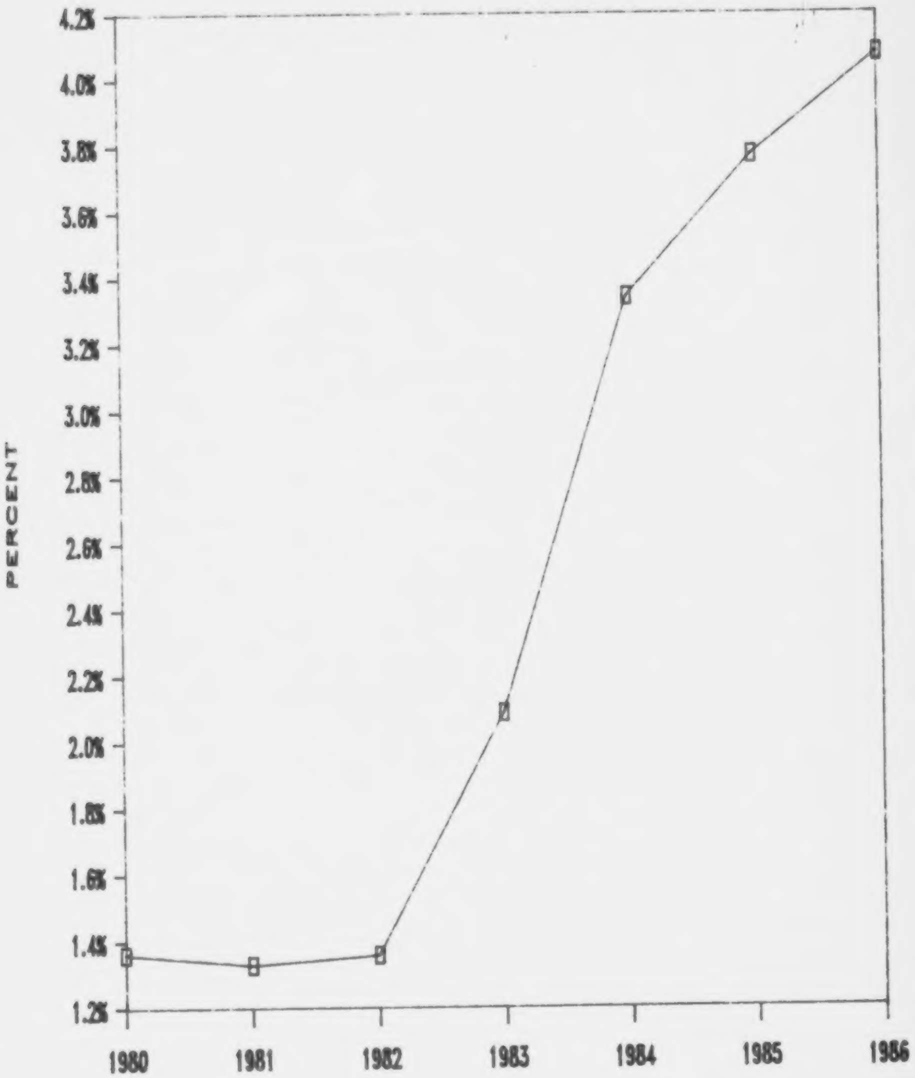


CHART XXV

NET ASSET POSITION OF THE U.S.

(1986 Estimated)

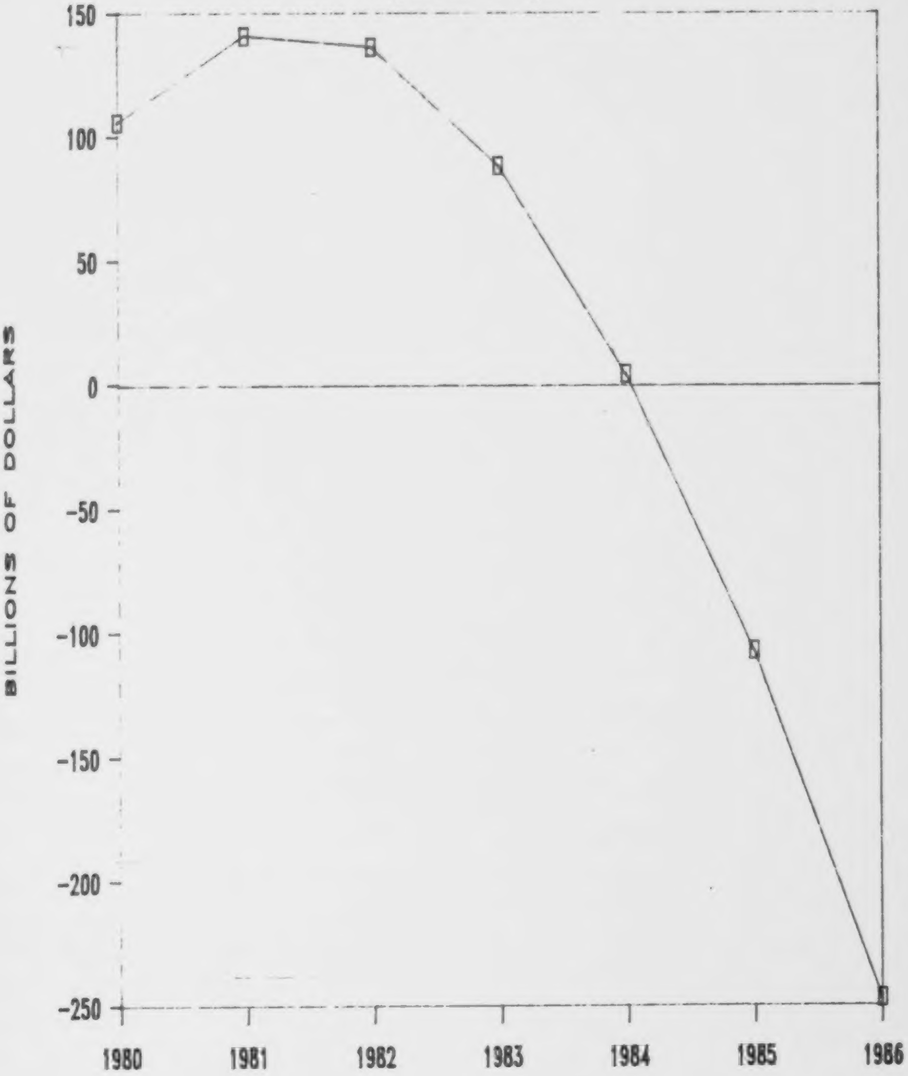
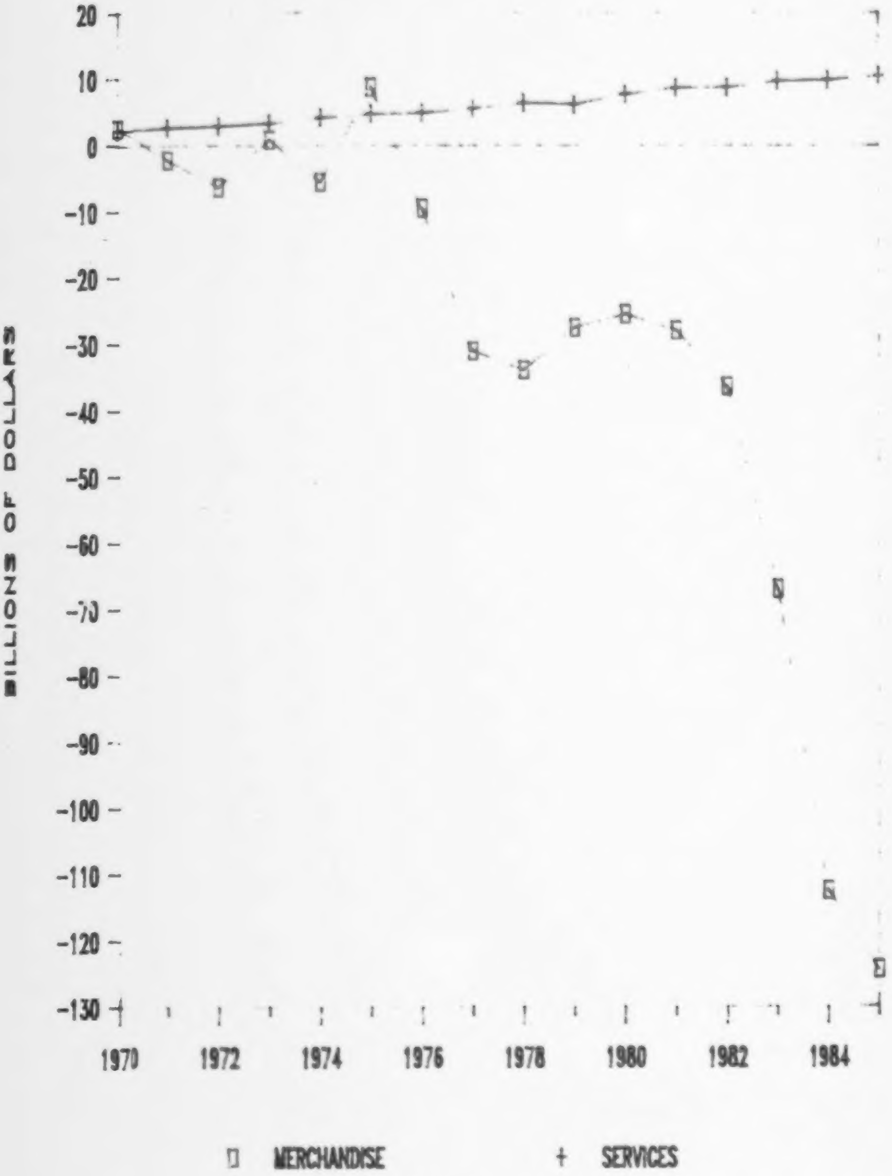


CHART XXVI

MERCHANDISE AND SERVICES NET TRADE



B. WHAT LIES AHEAD

This section of the Report is intended to assess what lies ahead for the American economy, keeping in mind that while it is not possible to predict the future with precision it would be imprudent to make important policy decisions disregarding future probabilities. In fact, the construction of forecasts and projections is a standard feature of economic analysis, widely employed in the private sector and required by statute of both Congress and the Executive.

The distinction between the two is important: forecasts are formal predictions of what will occur in the near term, that is, over a year or so, while projections are informed judgments of what might occur over longer periods, recognizing that economic, political, and other uncertainties make hard predictions impossible. Two or more projections are frequently made for the same period, using varying assumptions, in order to show how changes in one or more factors might alter the overall results. With respect both to forecasts and projections, their reliability depends greatly on the reasonableness of the assumptions underlying them.

1. THE SHORT-TERM OUTLOOK

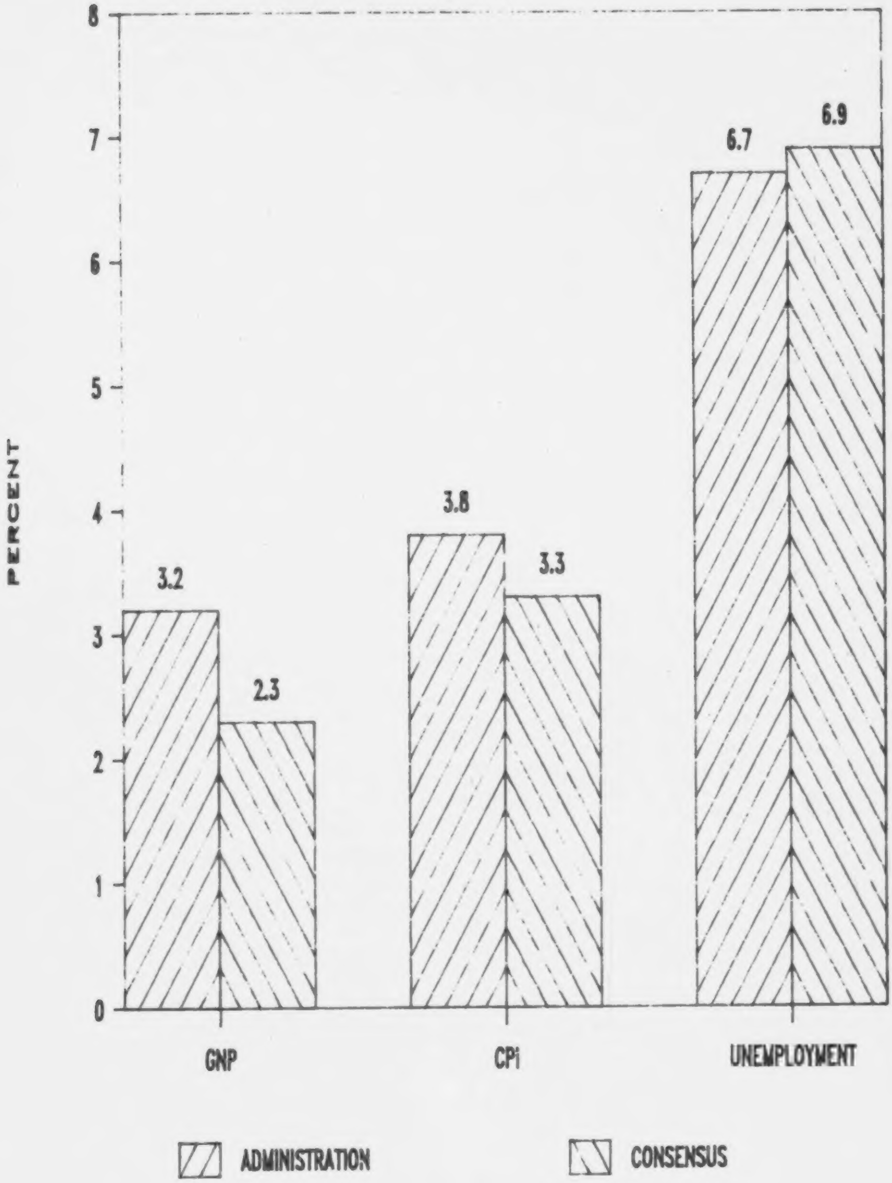
There is significant variation between the 1987 forecast presented in the Economic Report of the President and forecasts developed by analysts in the private sector. For 1987, the Administration forecasts the following: real GNP growth of 3.2 percent; a civilian unemployment rate of 6.7 percent; and an inflation rate as measured by the CPI of 3.8 percent. The Administration forecasts slight improvement in each category for 1988.

Most professional economic forecasters are more pessimistic than the Administration about the short-term prospects. While differing somewhat among themselves, witnesses who presented testimony earlier this year to the Joint Economic Committee all forecast lower growth rates, as does the consensus forecast of the Blue Chip Indicators, a composite of more than 50 forecasting firms and institutions. Chart XXVII summarizes the differences.

CHART XXVII

SHORT TERM FORECASTS

For 1987



Although the current Administration forecast is closer to the consensus than earlier ones, there is reason to believe it is unrealistic. First, the Administration's own assumptions of somewhat higher inflation, a slowdown in consumer spending, a substantial falloff in spending for housing, and budget constraints set by Gramm-Rudman-Hollings (GRH) all point to slower growth. Second, the Administration believes an increase in net exports will contribute significantly to economic growth in 1987. However, there are major uncertainties about how the fall of the dollar and slow economic growth here and abroad will influence trade.

The Administration assumes there will be import price adjustments to reflect the dollar's decline and expanded markets abroad for U.S. products. But even if the prices of foreign imports rise, U.S. exports are unlikely to increase on a major scale in the absence of resumption of economic growth among the world's debtor nations, particularly in Latin America, and major policy shifts in West Germany and Japan. The January trade deficit figures, somewhat larger than originally anticipated, raise the question whether the expected 1987 decline in the trade deficit will be sufficient to generate the modest growth predicted by the Administration.

Disagreement over the short-term forecast, while in a narrow band, is more significant than it may appear. A year ago, the Administration predicted GNP growth of 4.0 percent in 1986 and again in 1987, describing that rate as a return to healthy expansion after 18 months of "relatively sluggish" growth. Growth in 1985 had been only 2.7 percent, but instead of growing to 4 percent as predicted, it fell to 2.5 percent for 1986. The consensus forecast suggests that sluggish growth will continue, with all that implies for unemployment, productivity, and other problems.

2. THE LONGER TERM OUTLOOK

The Full Employment and Balanced Growth Act of 1978 requires the President to submit an annual long-range plan designed to reduce the unemployment rate to 4 percent within a period of five years. This year, as in the past, the Economic Report of the President fails to fulfill that requirement, instead providing what it calls "long-range" economic assumptions for the years 1988-1992. These assumptions project that real GNP will grow an average of 3.4 percent per year during the next six years. This is almost 40 percent higher than the average real growth actually achieved by the economy during the past six years. Even with six years of 3.4 percent growth, the Administration projects that the unemployment rate will fall no lower than 5.5 percent by 1992, still significantly higher than the 4 percent unemployment rate stipulated in the Act. Furthermore, the Administration offers little to substantiate its assumptions, saying that the projections are based on long-term trends, a continuation of current monetary policy, and enactment of Administration budget policies.

As in the case of the short-term forecasts, the Administration's longer term outlook is significantly more optimistic than those of the private forecasters. The Committee examined in detail long-term projections of three major forecasting firms, Data Resources, Inc. (DRI), Chase Econometrics, and Wharton Econometric Forecasting Associates. Each takes a longer look ahead than does the Administration. The Chase analysis goes through 1995, Wharton to 1996, and DRI makes 25-year projections through 2011.[2]

The private outlooks also vary somewhat in approach. DRI and Chase examine four scenarios incorporating varying assumptions: a "trend case" based on recent trends, a cyclical case assuming recurrence of typical business fluctuations, an optimistic case, and a pessimistic case. Wharton makes a single long-term "forecast," which includes the effects of the business cycle. Table II compares Wharton's forecast and the DRI and Chase trend-line projections for the period 1987-1996 with the Administration's long-term assumptions.

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[2] It should be noted that this discussion of the long-term outlook for the American economy has largely ignored the possibility of another cyclical downturn within the projection period. This omission is justified by the obvious difficulty in forecasting with any precision when and how the next cyclical downturn will occur. But it should not obscure the fact that the business cycle has not been repealed and that some cyclical variation in economic performance is likely to remain a part of a free-market economy.

Cyclical forecasts are only suggestive of future possibilities, but their implications should not be totally ignored. If potential business cycle effects were taken into account in developing future projections, the results would be more pessimistic than those based on a continuation of baseline trends. Today's recovery is long by postwar standards, and there are a number of significant imbalances in the economy which could set off a new recession within the next few years.

TABLE II

LONG-TERM OUTLOOK, 1987-1996

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Real GNP Growth										
Chase	2.4	2.7	2.7	2.8	2.8	2.7	2.8	2.7	2.8	--
DRI	2.6	3.1	1.9	2.8	3.1	2.6	2.4	2.4	2.4	2.4
Wharton	2.7	3.6	2.4	0.4	5.2	2.7	3.4	2.6	3.0	2.4
Administration	2.7	3.5	3.6	3.6	3.5	3.4	--	--	--	--
Inflation										
Chase	3.4	4.4	4.4	4.2	4.3	4.4	4.5	4.5	4.5	--
DRI	3.7	4.3	4.0	4.0	4.5	4.8	4.9	5.3	5.6	5.6
Wharton	3.5	4.9	5.2	5.6	4.8	4.3	4.6	4.9	5.5	5.4
Administration	3.0	3.6	3.6	3.2	2.8	2.2	--	--	--	--
Unemployment										
Chase	6.9	6.8	6.7	6.5	6.2	5.9	5.5	5.1	4.7	--
DRI	6.9	6.6	6.7	6.6	6.4	6.3	6.4	6.4	6.5	6.5
Wharton	6.9	6.5	6.6	7.5	7.1	6.9	6.7	6.7	6.9	7.4
Administration	6.7	6.3	6.0	5.8	5.6	5.5	--	--	--	--

The projections of the three private forecasters show sluggish average growth over the next 10 years, and inflation and unemployment rates somewhat higher than the Administration's assumptions. It should be noted that the DRI and Chase projections are relatively optimistic in that they assume no major mishaps or recessions. If less optimistic assumptions and possible recessions are taken into account, there would be slower growth and higher unemployment.

When the annual changes are examined, the differences between the Administration and the private forecasters are more striking. The Administration shows growth peaking at 3.6 percent in 1989 and then declining only slightly by 1992, while inflation and unemployment decline steadily. The three private firms see little or no improvement in the rate of growth of GNP throughout the entire period. Both DRI and Wharton see growth slowing down to 2.4 percent by 1996. The Administration assumes inflation will be 2.2 percent in 1992, while the three firms estimate it will be twice as high that year, and DRI and Wharton project about a 5.5 percent rate for 1996. Wharton projects a 7.4 percent unemployment rate in 1996, while DRI projects a 6.5 percent rate.

An important feature of the private outlooks is that the underlying assumptions in the projections are not particularly pessimistic and may even be overly optimistic. They assume no international shocks from supply interruptions or sharp price rises of the sort that occurred in the 1970's.[3] They concur in demographic projections of the U.S. Census Bureau showing a slowdown in the growth of the population and the labor force, a trend which would contribute to slower growth of output but would also help to prevent unemployment from rising much above current levels. All expect labor productivity growth to average about 1.5 percent annually during the next 10 years, a substantial improvement over the past 10 years. They assume that wage increases and consumer spending will be held down and that real interest rates will remain high, although Chase expects them to decline somewhat.

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[3] Both Chase and DRI provide alternative projections with less optimistic assumptions. By 1995, in Chase's low-growth scenario, real GNP growth is 1.5 percent, inflation is 6 percent, and unemployment is 6.6 percent. In DRI's pessimistic projection, real GNP growth is 2 percent, inflation is 7.4 percent, and unemployment is 6.9 percent in 1996.

With respect to oil prices, Chase assumes they will rise sharply in 1988 and 1989 and then grow by 6 percent annually through 1995. Wharton anticipates moderate price increases until at least 1996, and DRI sees no significant energy inflation until the mid-1990's. While their estimates obviously differ, none foresees price explosions of the magnitude that occurred in the 1970's.

Most private forecasters expect growth among the Western industrialized countries also to be sluggish over the next several years. For example, Chase projects Japan's annual growth to average 2.3 percent through 1990, and it projects the European members of the Organization for Economic Cooperation and Development (OECD) to average 2.4 percent. Such projections are consistent with the prevailing view in Europe. The OECD forecasts 2.75 percent growth for Japan in 1987, rising to 3.25 percent in the first half of 1988; and 2.5 percent growth for OECD Europe in 1987 and 2.25 for the first half of 1988.

The long-term average rate of economic expansion for the United States, prior to 1981, had been about 3.5 percent. This growth rate produced record numbers of jobs and accounts for the preeminent place of the United States in the global economy. Fueled by the ability to grow at even more rapid rates for sustained periods of time, and reinforced by the national commitment to goals such as full employment and low inflation, the U.S. economy has offered unprecedented opportunities for the American people and provided leadership for the rest of the world.

Economic growth is now averaging about 2.5 percent, and there is a broad consensus among private economists that we will continue on this slow path for the foreseeable future. This path raises a number of serious problems, however, especially with respect to unemployment and the trade deficit.

First, it will not be possible to achieve a significant reduction in unemployment at a 2.5 percent annual growth rate. The Administration's own projections show unemployment at 5.5 percent in 1992, well above the statutory goal but, in the opinion of most economists, still too optimistic. Private forecasters assume that at the current rate of growth unemployment will remain at about today's high level of 6.7 percent at least through 1996, with serious implications for the standard of living, poverty, and a host of related problems. Moreover, there are a number of developments that could cause unemployment to rise: a recession; or growth even more sluggish than projected; or more rapid growth in the labor force than currently anticipated.

Second, the most effective means to address the trade imbalance is to increase exports. In a period of sustained weakness, imports probably would decline as demand softened, but there would not be a corresponding increase in exports unless they are made more competitive. Assuring a stronger competitive position, however, would require greater emphasis on productive capital investment, research and development (R&D), productivity, worker training, and infrastructure, all more difficult to achieve in a period of slow growth.

Most economists expect productivity to be weak, Federal deficits to remain high, slow growth to continue in the Western industrialized nations and Japan, and short-term prospects for debt-burdened developing nations to remain inauspicious. As long as these conditions continue, world markets for U.S. goods are not likely to expand and net U.S. exports are not likely to grow.

CONCLUSION

Continuing growth, albeit tepid, and the absence of any obvious signs of recession obscure the extent to which the economy is vulnerable to abrupt dislocation, and the limited means available for responding to unanticipated problems. In the short term, slow growth represents a missed opportunity for the U.S. economy, and is particularly hard on the poor and unemployed who suffer most from slow economic growth. If growth increased to 3.5 percent, however, unemployment would fall, and would continue falling if growth stayed at the faster pace. In the longer term, the causes of today's sluggish growth, if untreated, will cloud the prospects for a healthy and competitive economy and raise the prospect of a declining standard of living in the United States.

II. THE CHALLENGES

A. THE DOMESTIC DIMENSION

The consensus among private economists is that present trends and policies will produce sluggish growth and relatively high unemployment over the medium and long term. This finding should be cause for both concern and action by government, since slow growth holds the economy well below its potential. Responsible economic policy must develop a way of getting higher growth and lower unemployment than the consensus forecast predicts.

Accepting the growth challenge means taking a hard look at the American economy, delving below the surface and recognizing the fundamentally new challenges which the economy faces. If the forecast is for sluggish growth, it is because the forecasters do not believe that successful responses have been developed to meet these challenges.

For this reason, the remainder of this Report is devoted to an analysis of the fundamental economic challenges facing the American economy -- challenges which must be met if the United States is to do better than the tepid growth and stagnant unemployment which the forecasters predict.

One of the principal obstacles to meeting the challenges of the future is the current impasse in domestic economic policy. Recent statistics tell of a slowing in the growth of incomes and an increase in the level of inequality in the American economy. Younger workers are finding it more difficult to earn enough to provide their families with the essentials of the American dream -- good housing, adequate health care, decent education, and a reasonable degree of retirement income security. If these trends are to be reversed, if the economic growth rate is to be raised, ways must be found to improve the ability of American producers to increase rapidly the efficiency and productivity of the entire economy, not just those firms which produce for export or compete against imports.

The challenges facing the United States range across the entire spectrum of economic activity -- from increasing the sluggish rate of productivity growth, to dealing with low savings rates, to renewing the economic infrastructure, to expanding investment in ideas and people, to reducing the growth disparities between sectors and regions.

Subsequent sections of this Report will address each of these areas in turn, seeking to identify the critical obstacles to stronger growth. Where obvious responses to these challenges are evident, we will draw conclusions for policy. In a number of areas where there is no obvious consensus on the best approach to meeting the challenges, we believe the constructive response is to start a national dialogue on the problem, not simply to ignore it.

Meeting the domestic and international challenges will require decisive action by government in a number of areas. Unfortunately, the legacy of the recent past makes it extremely difficult for government to use the traditional economic tools of fiscal and monetary policy to address these new challenges. This legacy makes anticipatory action now quite difficult, and may well cause a more serious crisis should economic policy be asked to cope with the strains of a new recession.

The dilemma is clearest on the fiscal side. Central to the debate about meeting the challenges of the future is the problem of the Federal budget deficit. The deficits built up over the last six years constitute an immense claim on the future output of the economy, and it is important for future generations that steps be taken to bring the deficits down now.

The nature of the budget problem is portrayed in Chart XXVIII and Chart XXIX. The first shows the pattern of growth in Federal revenues and expenditures since 1970. Expenditures have continued to rise at a rate of growth similar to the pre-1980 historical average, but revenues dropped sharply in 1982-1983 and since then have not grown at a rate sufficient to close the gap with expenditures.

The second chart demonstrates clearly that the reason for the continued upward momentum reflects in part greatly increased purchases of defense-related goods and services. In real terms, civilian purchases in 1986 were 8 percent higher than their 1980 levels, but defense purchases were some 46 percent higher.

CHART XXVIII

FEDERAL GOVERNMENT

RECEIPTS AND EXPENDITURES

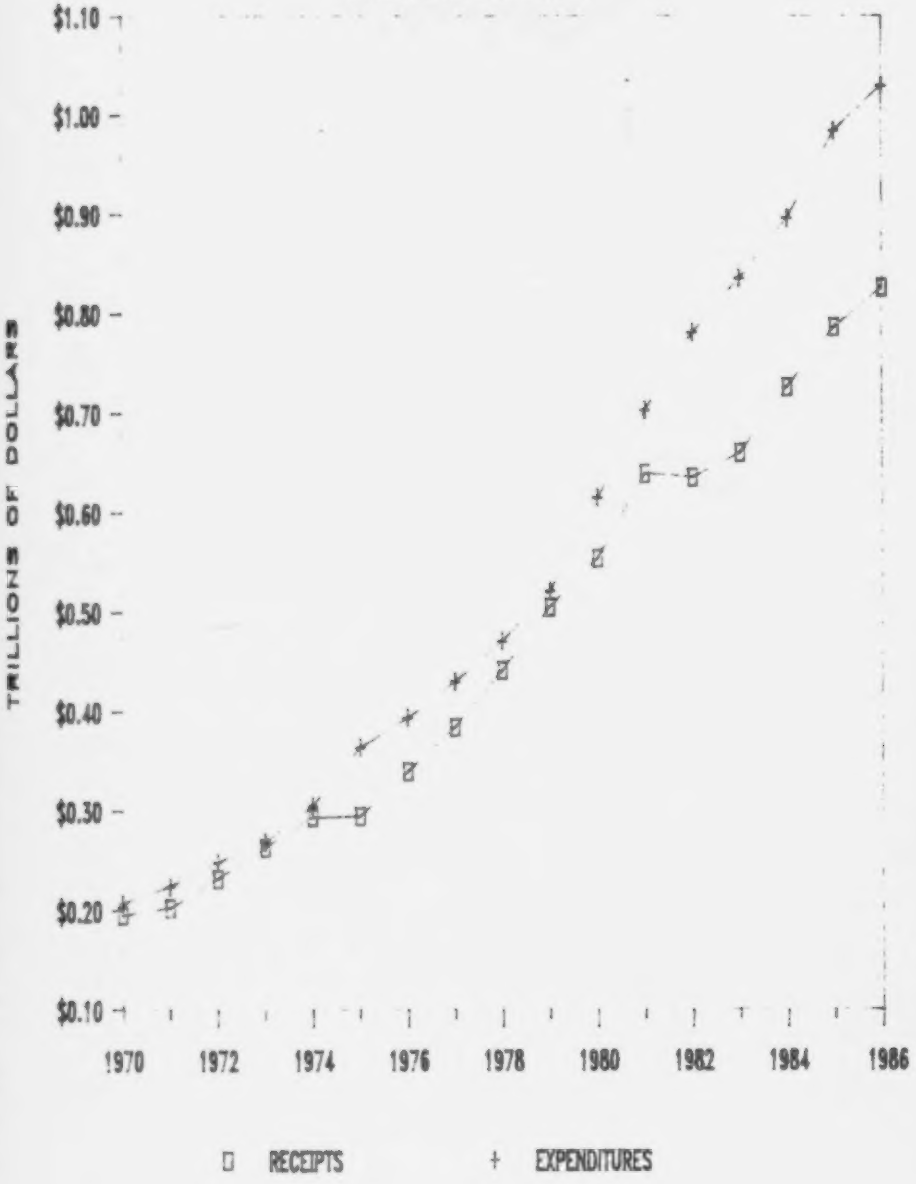
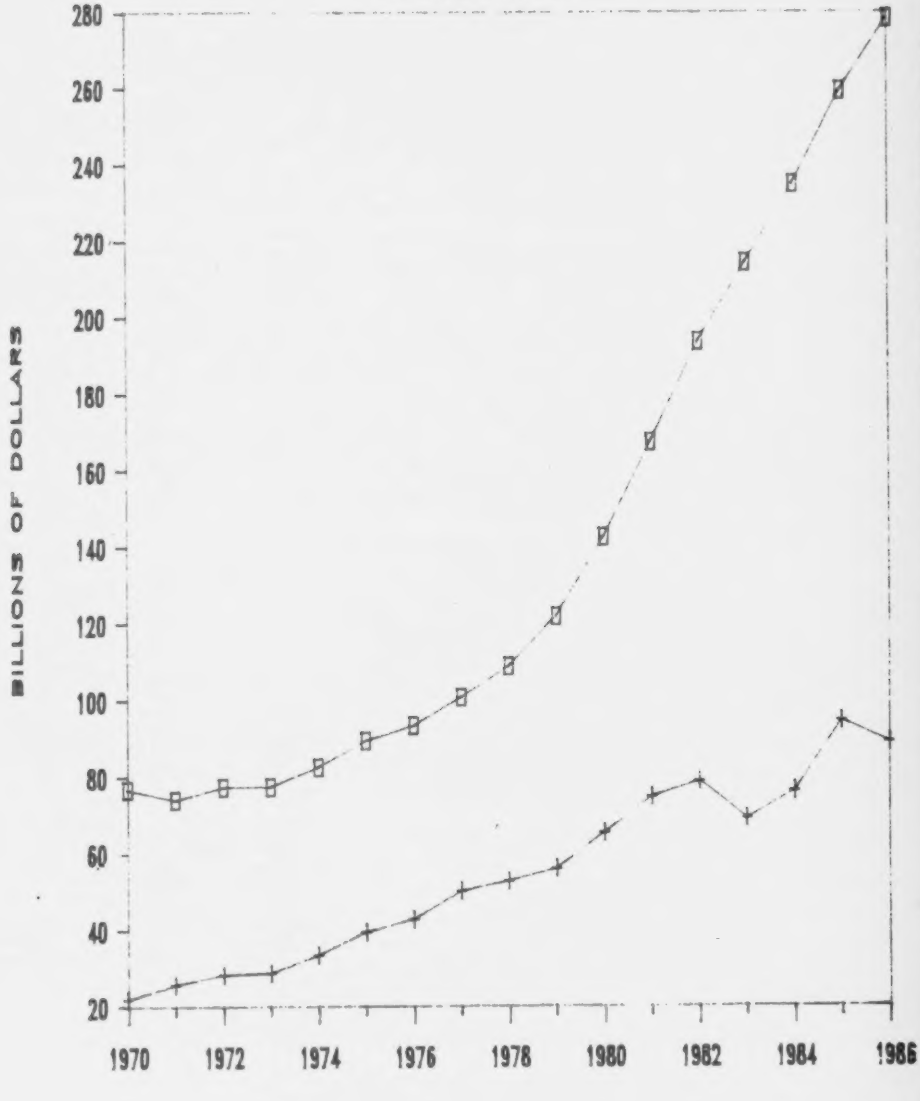


CHART XXIX

FEDERAL GOVERNMENT PURCHASES

MILITARY AND CIVILIAN



The deficit problem is thus caused by a sharp rise in defense spending and a sharp reduction in the revenue base.

This year, there appears to be a notable shift in Administration budget policy. As Treasury Secretary Baker told the Committee:

> Some have suggested that our budget is a carbon copy of previous budgets and I think nothing could be further from the truth...we are recommending $22.4 billion in deficit reduction through changes affecting receipts. Over half of this amount involves temporary measures that do not represent a permanent revenue stream...while the remainder of the receipt changes do represent permanent revenue proposals....

Such statements represent a departure from previous budget policy, and suggest that the Administration may be moving toward acknowledgment of the need for a balance between revenue and expenditures in the budget process.

Such changes, however, may be too late to avoid a dangerous fiscal policy situation created by GRH passed last year. That legislation, which was strongly supported by the Administration, establishes a rigid formula for balancing the budget by 1992 which could potentially create serious economic problems in the year ahead.

Steady and responsible budget reduction needs to be integrated with two other priorities: the need to assure economic growth, and the need to address a number of key problems which are standing in the way of economic growth.

Balancing economic growth with the deficit targets established by last year's GRH law is likely to be exceptionally difficult in the coming year. Sluggish growth -- the consensus forecast for the coming year -- in the past two years has been associated with a rising deficit, suggesting trouble ahead for the deficit in a slow-growth economy.

To ignore this reality, and impose large reductions in the deficit on a weakened economy, runs the risk of tipping the balance from sluggish growth into recession. A year ago, the Committee took the view that the strength of the economy at that time would permit the deficit reduction required under GRH in FY 1987 without precipitating a recession. The outlook this year is much less certain. A substantial contraction of Federal fiscal stimulus, which would be required to reach a deficit target of

$108 billion, runs the risk of imposing too big and too sudden a burden on an already aging recovery. As Allen Sinai, Chief Economist of Shearson Lehman Brothers, told the Committee:

> A point of no return has been crossed where it is now counterproductive to explicitly and actually meet the GRH targets. Even if attempted, the necessary adjustments by the Federal Reserve to compensate for the lost economic activity could not be taken quickly enough nor coordinated well enough to smooth the adjustment process in an economy that is already fragile.

Fiscal policy -- as constrained by GRH -- thus poses some threat to sustained economic growth. The threat is made more severe by the relative inflexibility of the recession provisions in the GRH law. Constraints on fiscal policy are removed under GRH only after two consecutive quarters of growth under 1 percent or when either the Congressional Budget Office (CBO) or Office of Management and Budget (OMB) projects a recession. Yet the economy could be moving deep into recession because of fiscal policy before the required two quarters of data could be posted. According to Allen Sinai:

> Although the GRH legislation contains a trigger mechanism that shuts off spending cuts once real growth declines, the negative growth would be perceived too late to prevent accelerating weakness.

The "escape clause" provisions of GRH have another serious limitation in terms of fiscal policy. Two quarters of less than 1 percent growth or a forecast of a recession remove the deficit ceilings, but for that fiscal year only. Once the economy began to grow again, the law would require the Federal budget to return to the targets established in the original law, with no adjustment in the target to reflect the interim year in which the law was suspended. If a recession caused suspension of the deficit target and a rise in the deficit, the law would require massive new budget cuts to meet the old targets in the subsequent recovery year. Such an extreme fiscal drag could easily suffocate a recovery and ensure that the economy would be thrust back into recession again. For this reason, GRH may have the effect of deepening and prolonging any recession.

The issue of macroeconomic fiscal stimulus is only one of the threats posed by the current budget dilemma. As everyone, including the Administration, now recognizes, there are clearly areas in which meeting the challenges of the future require an increased, rather than a decreased, Federal commitment. It is impossible to safeguard the long-run growth potential of the economy if prudent current investments by government are neglected.

These concerns suggest that both the spending and revenue sides must be considered if the budget deficit is to be put on a sustained, downward path. At the same time, this "glide path" should not be so steep as to drive the economy into recession (which would only exacerbate the deficit problem), and the balance between revenues and spending should not be so rigid as to force the government to ignore needed initiatives in areas critical to economic growth.

If fiscal policy is constrained by the history of large deficits and the GRH law, monetary policy is constrained by a different set of factors associated with the dollar and the trade deficit.

For the past two years, the Federal Reserve has been able to pursue an aggressively expansionary monetary policy without running into serious inflationary problems or serious foreign exchange problems. In fact, the generally recognized need to lower the value of the dollar in the past made it easier for the Federal Reserve to permit interest rates to fall. Domestic needs for lower interest rates as stimulus to investment coincided with international needs for a reduction of interest-rate differentials and a lower dollar.

This relatively benign confluence of events is coming to an end. There is now substantial concern about the inflationary effects of a declining dollar and the buildup of monetary pressure arising from the recent rapid growth in the money supply. At the same time, the increased reliance on foreign sources of capital in American investment markets means that the Federal Reserve can no longer be as aggressive as in the past in lowering interest rates and driving the dollar down.

In this new context, monetary policy may not be as readily available as a policy tool to combat subsequent weakness in the economy. With today's dependence on foreign capital inflows, and the inflationary potential of further dollar devaluations, monetary policy might be unable to play a stimulative role should the economy turn soft. If the Federal Reserve feels compelled to defend the dollar, this may sharply constrain monetary policy whatever the consequences for interest rates and the domestic economy.

Interest rates show signs of beginning to drift upward, a possible indication that the era of monetary stimulus may well be at an end. Concerns about inflation and the value of the dollar could force the Federal Reserve to maintain or even raise interest rates in response to a perceived weakening of the dollar or a renewal of inflation, as Chairman Volcker indicated in his February 2 testimony before the Committee.

Taken together, the outlook for fiscal and monetary policy is thus not very encouraging. It is possible that our policy apparatus will be able to sustain a sluggish rate of overall economic growth. But the traditional tools of macroeconomic policy are not now capable of contributing to a strong surge in economic growth, nor do they appear adequate to the task of moderating any future recession.

B. THE INTERNATIONAL ECONOMIC ENVIRONMENT

1. U.S. INTERNATIONAL TRADE

The unprecedented 1986 U.S. trade deficit of $169.7 billion is an urgent signal of serious problems in the U.S. economy, and in U.S. economic policy, that cannot be ignored. As the 1987 Report of the Council of Economic Advisers notes:

> By any measure, the United States has experienced an unprecedented deterioration in its international payments position.

The 1986 trade deficit surpassed the previous record of $148.4 billion, set in 1985, by about 15 percent and represents about a 4 percent share of GNP, a situation often characteristic of developing countries.

The United States has had a small merchandise trade deficit since 1975, but that deficit has more than tripled over the past six years. The magnitude of the increase has caused the U.S. current account, which includes investment income and trade in services as well as merchandise trade, to shift from surplus to deficit. While the United States has occasionally posted current account deficits for a single year, the current account has generally been in surplus, resulting in a steady accumulation of foreign assets by American investors. This net creditor position has been sharply eroded in recent years, and today, for the first time in 65 years, the United States is a debtor nation instead of a creditor.

The new status of the United States as debtor nation creates an entirely new set of pressures on the traded-goods sector. Traditionally, the United States could tolerate a modest merchandise trade deficit because investment income on our assets was more than sufficient to offset these deficits and keep the current account in balance. Now investment payments to foreigners are greater than U.S. investment income from abroad, and add to the current account deficit rather than subtracting from it.

While the United States has been borrowing heavily from abroad in the past five years to finance the current account deficit, there is little doubt that this pattern must stop eventually. Foreigners will not be willing to lend indefinitely to a country living beyond its means. To end borrowing will require at least a balance in the current account, and a current account surplus would be required to reduce the size of the U.S. external debt. Balancing the current account in the presence of substantial net interest outflow on the existing debt means posting a large surplus on merchandise trade. Since the United States has posted a merchandise surplus in only three years since 1970, the task facing the traded-goods sector is formidable.

a. Trade Patterns Since 1980

Deterioration in the U.S. account has been extremely broad-based. As the 1987 CEA Report states:

> The trade balance has deteriorated against virtually all major trading partners and in virtually all major product categories.

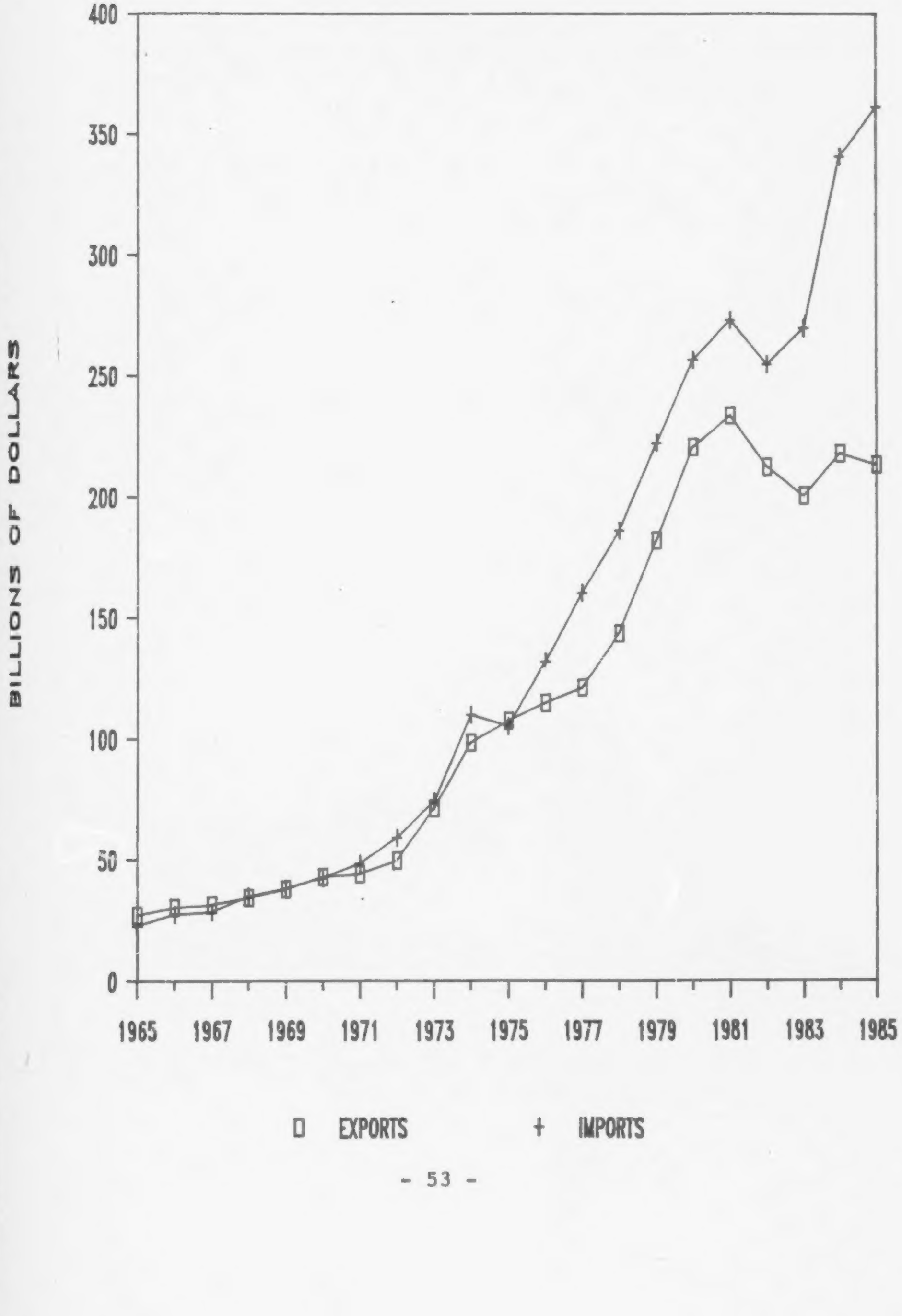
Stagnation or decline in exports from virtually all sectors of the U.S. economy, combined with sharply rising imports, caused a decline in the overall merchandise trade balance including sectors such as manufactured goods, services, food, and high technology.

b. Trade in 1986

Because the value of the dollar reached its peak on foreign exchange markets in February 1985, and declined steadily thereafter, in theory reducing the price of U.S. goods abroad and raising import prices, it was widely assumed that the U.S. trade balance would begin to improve in 12-18 months' time. While prices rose for selected imports -- about 20 percent in the case of photographic equipment, optical goods, and cutlery; 10-20 percent in the case of automobiles, electrical equipment, glassware, pharmaceuticals, and watches -- export growth continued to lag the growth in imports. The monthly average of U.S. exports in fourth quarter 1986 was $18.7 billion compared to $17.4 billion in fourth quarter 1985, a rise of $1.3 billion, while the comparable figures for imports were $32.7 billion and $31 billion, a rise of $1.7 billion, and more than 30 percent greater than the rise in exports. The trade deficit for just the last quarter of 1986 was higher than the trade deficit for any full year prior to 1982.

CHART XXX

U.S. TRADE GROWTH



The prospects for significant rapid improvement in the trade deficit are limited. According to the CEA Report, "after deducting 0.7 percent from economic growth in 1986, real net exports are expected to contribute a similar amount to growth in 1987." In commenting on the trade deficit figures, however, CEA Chairman Beryl Sprinkel told the Committee:

> And the best you can say even up until today, in my opinion, is that it ceased getting worse. We think it is on the verge of improvement. There was a slight seven plus billion improvement in exports in the fourth quarter in the first preliminary estimate of GNP, but we haven't really started a significant improvement in that area yet. We think it will happen.

Controversy continues over the failure to improve the trade balance in 1986, and indeed over the degree to which the dollar has declined on foreign exchange markets in the last two years. The traditional Federal Reserve index shows a rise in the dollar of more than 40 percent in 1980 to March 1985, and a 32 percent decline since then. It must be kept in mind, however, that the Federal Reserve index is based on historical rather than contemporary trade patterns and attaches much greater weight to the European industrial countries than to U.S. trading partners in Asia. As a consequence, it reflects less than 60 percent of U.S. global trade volume and may not be a fully accurate gauge of the dollar's value.

c. Barriers to Trade

In the short term, foreign trade barriers that keep U.S. products out of markets abroad protect jobs abroad and make it difficult for the United States to earn foreign exchange from exports, thereby aggravating the trade deficit.1/ With reliance on non-tariff barriers, which are less readily identifiable than overt tariffs and quotas, there are indications that the use of unfair trade practices by U.S. trading partners has grown in the 1980's.

1/ Japan is one of the worst offenders in this regard. DRI has projected that reduction in Japanese trade barriers would boost U.S. domestic employment by 250,000, including 100,000 jobs in manufacturing.

The number of petitions filed by U.S. firms with the International Trade Commission (ITC) alleging unfair trade practices by foreign firms has risen dramatically. In the 1955-1975 period, the average number of petitions filed annually asserting dumping in the United States by foreign firms of products at below-market prices was 24; since 1982, that average has more than doubled. From 1972 to 1981, the annual average of petitions alleging the use of unfair government subsidies abroad and requesting the imposition of countervailing duties was less than 14; the average since 1982 has been 51.

d. Trade Law Enforcement

Imports

Enforcement of existing U.S. trade laws has reinforced trends toward managed trade and more restrictive trade laws.

The General Agreement on Tariffs and Trade (GATT), to which the United States and 91 other trading nations subscribe, includes "escape clause" provisions explicitly designed to permit temporary relief for industries in process of adjustment to changing trade patterns. Escape clause import protection can be provided to give firms showing injury a breathing spell while adjusting to vigorous but fair competition from abroad. However, U.S. trade laws give the President the authority to refrain from invoking the temporary escape clause provisions of the GATT, and the Administration has exercised that authority to deny relief in three of the six instances where the ITC has made a formal finding of injury.

The Administration has preferred instead to negotiate orderly marketing agreements in which import restraints are negotiated independent of market conditions. These managed trade agreements do not adequately deal with the fundamental issues of industrial adjustment and foreign trade barriers. Furthermore, they are readily circumvented by foreign competitors who deliberately take steps to soften the impact -- e.g., Japan and semiconductors; or by competitors who were not a party to the negotiations -- e.g., the Koreans with respect to auto imports.

TABLE III

UNFAIR TRADE PETITIONS (1955-1986)

Year	Dumping	Foreign Government Subsidies
1955-1971	417	--
1972	39	4
1973	27	2
1974	10	3
1975	10	32
1976	28	14
1977	19	16
1978	47	28
1979	30	15
1980	40	10
1981	19	15
1982	68	124
1983	47	34
1984	48	42
1985	46	29
1986	68	28

Source: Congressional Research Service

The Administration's refusal to invoke the escape clause provisions under GATT also has caused domestic firms facing undue competition to seek relief under existing U.S. law, rather than through the international GATT. Escape clause filings since 1981 have been at barely one-third the pace of the late 1970's as domestic firms have turned instead to the anti-dumping and countervailing duty provisions of U.S. trade law. These laws provide compensatory tariff protection for U.S. firms faced with competition from foreign firms selling below cost (dumping) in the United States or enjoying government subsidies for their products. Petitions for relief under both the anti-dumping and countervailing duty laws have risen dramatically during the 1980's and the number of petitions being found meritorious by the International Trade Administration in the Commerce Department and the independent International Trade Commission has more than doubled.

Exports

Administration export policy also has been wanting. There has been no serious effort to address the fact that the existing export tax exemption program does not offset foreign border tax rebates to competitors abroad, or that the existing export financing by the Export-Import Bank (Eximbank) and other programs is inadequate when compared with foreign competitors. More fundamentally, the Administration has failed to stem the use of export subsidies abroad, particularly European Community (EC) subsidies for agriculture export designed to shrink internal surpluses; the threat earlier this year to impose very high tariffs on cheese, alcoholic beverages, and wine reflected the magnitude of this festering problem, and the extent to which the Administration had to respond with a threat carrying severe implications.

Unfair trade practices abroad affecting U.S. exports are the subject of Section 301 petitions filed under the Trade Act of 1974 by private industry. Since Section 301 cases are directed at foreign-government targeting and other unfair trade practices, industry complaints must be resolved through U.S. Government negotiations, either on a bilateral basis or through the GATT if the government in question is a member of GATT and the issues are within the purview of GATT.

In an independent review of the record, the General Accounting Office (GAO) concluded that "Section 301 has not provided substantial results" in removing trade injury. In evaluating all Section 301 cases initiated or pending between 1980-1985, GAO found the average period required for dispute settlement to be 34 months -- virtually three years. Evaluating the success of Administration negotiators in these cases, GAO found effective remedies achieved in only three of the 35 cases surveyed. In addition, the Administration has not forcefully taken up cases -- e.g., Korean insurance and Japanese leather import barriers, where foreign governments have reneged on Section 301 agreements. It should also be noted that the Administration did not initiate any Section 301 cases prior to the fall of 1985, when the problem already had reached urgent proportions.

e. Future Trade Policy

In addition to the broad economic policy mismanagement underlying the alarming deterioration in the U.S. trade position, protracted indifference to currency misalignment and failure to implement existing GATT provisions and U.S. trade laws are also important factors.

A new round of negotiations in the GATT opened late last year and is scheduled to continue for several years. Since GATT is the international forum for resolving trade disputes, the negotiations offer a clear and immediate opportunity to identify and rectify unfair trade practices. Unfortunately, the objectives outlined by the Administration thus far are relatively limited, focusing on trade in services, trade-related investment, agriculture, and improvements in escape clause provisions and intellectual property rights. Failure of the Administration to make a forceful commitment in principle to strengthen GATT's role as a guarantor of free trade has diminished GATT's effectiveness and accelerated the decline toward managed trade.

f. Effects of the Trade Deficit on Growth

Economic Growth

The explosive growth in imports and stagnation in exports during the 1980's has retarded economic growth, job growth, and income growth. Real domestic demand rose 3.5 percent in 1981-1986, but GNP grew only 2.5 percent with the trade gap being responsible for the difference. Had the trade balance not deteriorated since 1981, economic growth in the 1980's would have exceeded the pace of the preceding decade. In contrast, according to a recent report by the ITC, 42 percent of Japan's economic growth in 1983-1984 was directly due to export surplus.

Job Loss

Any method of measuring the employment effects of trade deficits raises significant conceptual problems. Perhaps the most useful analysis was prepared last year by David Lund of the

Policy Division of the Department of Labor. Using output ratios, Lund determined that deterioration in the trade balance was responsible for the loss of two million domestic jobs in 1981-1983. (This figure is the sum of direct and indirect employment loss. It includes job loss in export industries due to productivity growth in the face of stagnant volumes as well as job loss in import-competing industries and agriculture.) Manufacturing was the source of over one-half of the jobs lost in exports and nearly all of the jobs lost in import-competing industries during this period. On that basis, about 1.3 million, or three-quarters of the 1.7 million manufacturing jobs lost in 1981-1983, were trade related. While the Lund analysis does not extend beyond 1983, the accelerated broad-based deterioration in the trade balance since then would suggest that the trade deficit continues to act as a brake on employment growth.

The attrition in jobs has taken place despite a diminishing growth in the labor force which has lessened pressures for job creation. Compared to the annual labor force growth rate of 2.7 percent in the 1970's, the average growth rate since 1980 has dropped by 40 percent to 1.6 percent.

TABLE IV
JOB LOSS DUE TO TRADE
(1981-1983)

Export-Related:	1.1 million
Import-Competing:	0.7
Agriculture:	0.2
	2.0 million

Source: "Employment Effects of U.S. International Trade Changes," David Lund, Department of Labor, January 14, 1986

Income Growth

The rising trade deficit has been reflected in the distribution of the 9.1 million jobs created since 1981, where nearly one million manufacturing jobs have been lost while nearly 10 million have been added to the labor-intensive service-sector work force. The 1987 CEA Report, recognizing this trend, noted that:

> Although many employees in service-sector industries (such as health care, and banking and finance) are high-skill, high-wage workers, wage rates in service-sector industries are generally below average wage rates in manufacturing, indicating that skill levels are also lower. Specifically, wage rates are relatively low in the two service-sector industries (retail trade and business services) that have recorded the strongest employment gains since 1981.

Even in manufacturing, total compensation in the United States since 1980 has lagged behind growth in compensation abroad. Bureau of Labor Statistics (BLS) data indicate that, over the past six years, real compensation for workers in manufacturing in six major trading competitors has grown much more rapidly than in the United States, so that several countries now nearly match U.S. levels.

The loss of higher paying jobs in manufacturing, and this past year in the mining and minerals sectors, plus the concentration of job growth in lower paying service jobs, has retarded income expansion. Average weekly earnings in the private nonagricultural sector were $172 in 1980 (1977 dollars) but $170.3 in December of 1986.

g. Remedies

The decline in the trade sector is in large part responsible for the erosion in economic, employment, and income growth since 1980. A broad range of trade and economic policies, carefully developed and implemented, will be required to reverse the trend.

It will be difficult to eliminate the trade deficit through import shrinkage. Major trading competitors will be reluctant to give up hard-won shares of the U.S. market, as the willingness to cut profit margins in the face of less favorable currency exchange rates suggests. More to the point, to the extent that reduced import levels mean reduced U.S. consumption, they will mean a decline in the domestic standard of living.

Historically, the most frequent solution to the trade deficit problem has been to cut consumption dramatically. This is a familiar pattern in the Third World, where countries with current account deficits exceeding 3 percent of GNP are often required, as a condition of assistance from the International Monetary Fund (IMF), to implement stringent austerity programs that cut demand, raise unemployment, and in effect engineer recession. Curbing the deficits through demand restraint is not unknown in the United States. Domestic demand declined significantly in the 1974-1975 recession, transforming the 1974 merchandise trade deficit of $11 billion into the 1975 merchandise trade surplus of $2 billion.

The immediate task is therefore to redress a trade imbalance which if left uncorrected may lead to a recession, and to do so through a policy framework that embraces world economic growth, currency revaluation, more open markets abroad, and trade policy reform at home.

Even assuming an export orientation is achieved, the problems of export expansion should not be underestimated. In 1986, merchandise imports were 60 percent larger than exports, so that exports would have to increase 60 percent faster than imports simply to keep the trade balance from deteriorating. Sustaining such differential growth rates for a prolonged period will be extremely difficult.

2. WORLD ECONOMIC GROWTH

As important as a new export orientation is on the part of the American economy, it will be ineffective in the absence of increased demand abroad for U.S. products. For the past six years, the United States has been virtually the world's only source of import demand growth, in effect supporting the economies of other major trading nations by importing their products. In the 1968-1977 decade, world trade measured in volume terms grew at an annual rate of nearly 8 percent. Since then, the growth rate has declined by more than half, to 3.2 percent. World trade volume was stagnant in 1980-1983 in the wake of the 1979 oil price shock, grew 8.6 percent in 1984, but declined again to an annual rate under 4 percent in 1985-1986. Yet in 1984-1986, U.S. import volume expanded by more than 42 percent, according to the IMF, while the comparable figure for Europe was 19.4 percent and for Japan was 19.5 percent. Securing a foothold in the U.S. market has become a cornerstone, perhaps the cornerstone, of other nations' trade policies. The experience of the past two years, when the dollar fell sharply against other currencies, suggests that the foothold, once secured, is not easily reduced.

a. Demand Growth in the Industrialized World: Limits and Possibilities

The industrialized nations of the world, particularly the EC, Japan, and Canada, are by far the most important American trading partners, accounting for roughly 57 percent of U.S. exports and imports.

For the past several years, domestic demand growth in the other industrialized nations has fallen below the historical average growth rate of 3 percent, reaching only 1.5 percent in 1983, 1.9 percent in 1984, and 2.3 percent in 1985. In addition to the downturn in demand, other characteristic signs of stagnation or recession have appeared. In Europe, unemployment is generally in the 9-11 percent range and substantial excess capacity exists in the manufacturing sector. In Japan, unemployment has also risen to a postwar high of 2.75 percent, and economic growth has fallen to 2.25 percent, less than half the 1984 rate. Prudent analysis would suggest opportunities for expansion and demand growth in the industrialized world without at this time incurring problems of supply bottlenecks or renewed inflation.

Nonetheless, Administration efforts to induce faster growth policies, particularly in Germany and Japan, thus far have had limited success. Fiscal policy in virtually every other industrialized country has been restrictive and monetary policy has also been relatively tight, particularly in West Germany which has resisted repeated requests by France and other European nations for reduction in its very high interest rates. Latest OECD projections suggest that in 1987 the growth rate in Germany and Japan will not exceed 3 percent, the weakest since the recession of 1981-1982.

Assuming current trends, there is little reason to expect a significant shift in existing trade balances. An OECD staff analysis foresees the possibility of continuing U.S. current account deficits in the range of $100 billion and 2.4 percent of GNP "for many years to come."

While faster growth in Europe and Japan would have a positive effect on the U.S. trade balance, its importance should not be exaggerated. The October 1986 IMF World Economic Outlook concluded that a one percentage point increase in domestic growth in Japan and Germany, even if maintained over three years, would have an effect on the U.S. trade balance in the $5-$10 billion range since the industrial structures of the two nations are similar to the American and income elasticities of demand for U.S. exports are very modest.

b. Demand Growth in the Developing World: Limits and Possibilities

Because of the limited potential for growth in the industrial world to reduce the U.S. trade deficit, resumption of demand growth in the developing world is central to restoring a healthy world trade balance and indeed to the health of the world economy. In contrast to the industrial nations, developing nations -- particularly in Latin America -- have shown a much higher propensity to consume imports as their economies expand. Between 1976-1980, for example, the developing world accounted for 44 percent of the net increase in U.S. exports, even though their average share of U.S. exports was only 37 percent. For the entire decade of the 1970's, the growth rate in U.S. exports to the developing world significantly exceeded the growth rate in exports to the industrialized world.

A major factor in improving the U.S. trade balance will be assuring a resumption of healthy growth in the Third World, and reversing the drastic economic contraction brought on by the debt crisis. Growth will be difficult, however, so long as the debt crisis remains unresolved. Economic theory and historical example both argue that borrowing from abroad is a sound and indeed necessary practice for developing countries which have abundant natural resources and labor but insufficient savings and equipment to develop them. Savings are limited by low levels of national income and inadequately developed mechanisms for promoting savings, while equipment is not yet manufactured domestically and must be obtained from abroad. Countries facing import and savings constraints can increase growth rates substantially by borrowing resources from abroad -- as the United States, Canada, and Australia did at earlier periods in their economic development, repaying loans used to finance development as productive capacity expanded and trade deficits turned into trade surpluses.

The expansion in borrowing prevalent in the developing world in 1968-1977 permitted an annual growth of import volume of 9.2 percent at a time when industrial world imports expanded at a slower (but still considerable) 7.4 percent annual rate. While the annual average growth rate in the industrialized countries declined in 1973-1982 in response to the oil crises to 2.8 percent from 4.4 percent in the previous 15-year period, the growth rate in the non-oil Third World declined only marginally over the same period, from 5.8 to 5.1 percent. Expanded borrowing provided the buffer against reduced imports and reduced growth rates that price increases would otherwise have required.

The 1982 announcement by the Mexican government that payments would be suspended on outstanding debt focused attention on changes in economic conditions in the Third World, brought on by declining commodity prices on the one hand and the rising interest rates on the other. Export earnings were no longer adequate to finance both debt service and domestic growth, and new bank borrowings declined.

TABLE V

NET EXTERNAL BORROWINGS FROM PRIVATE CREDITORS

	1981	1982	1983
Total Developing World	74	48	17
15 Heavily Indebted Countries*	56	29	-2.6

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* These countries are: Brazil, Argentina, Peru, Ecuador, Bolivia, Colombia, Mexico, Venezuela, Chile, Uruguay, Ivory Coast, Philippines, Nigeria, Morocco, and Yugoslavia.

Source: IMF World Economic Outlook

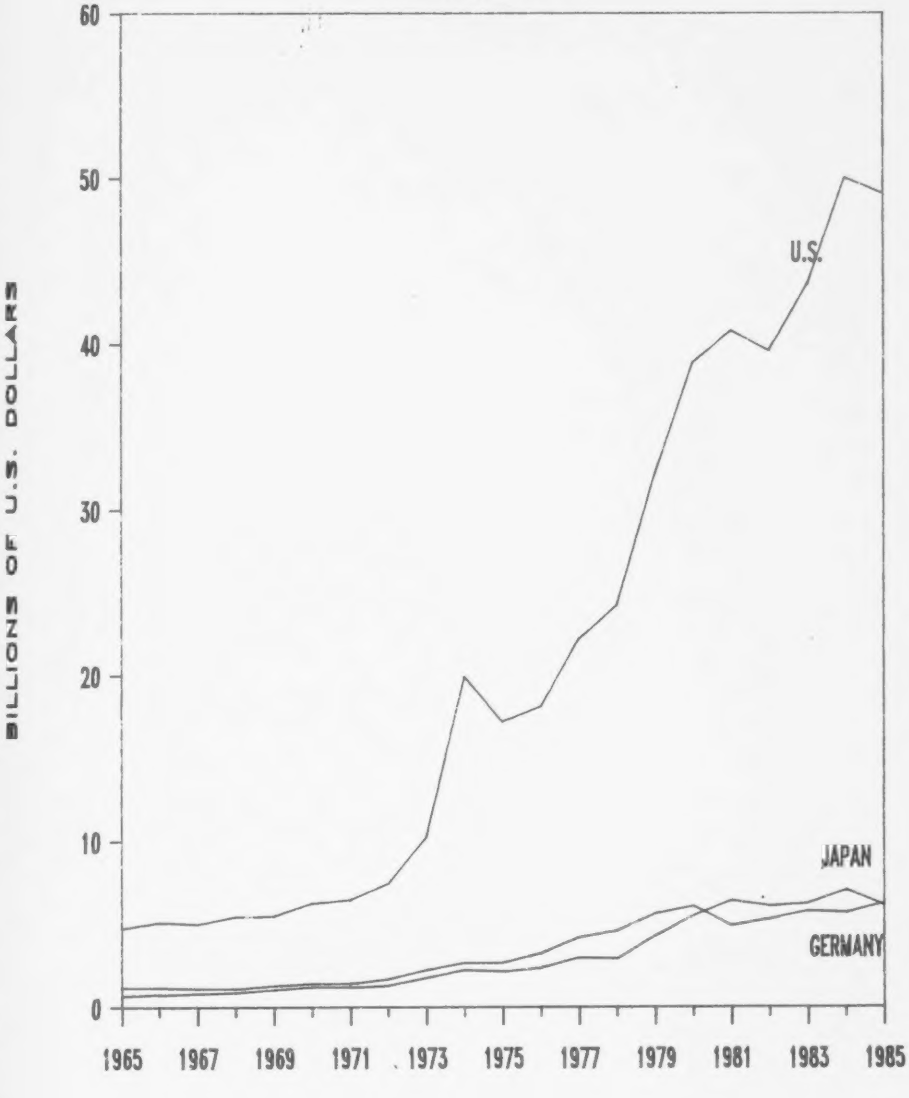
In response to creditors' pressure for expanded exports and curtailed imports to assure debt service payments, imports to the 15 heavily indebted countries declined by 36 percent in volume terms since 1981.

The Latin American experience is especially important to the United States. Between 1981-1984, the trade balance in Latin America moved from a $4 billion deficit to a $38 billion surplus, a $42 billion swing attributable largely to import reductions. The effect on U.S. exports was immediate and dramatic. Over that same period, U.S. iron and steel exports to Latin America fell 73 percent, construction equipment exports to the region fell 75 percent, and agricultural machinery exports dropped 71 percent. On a broader scale, the IMF estimates that import restraint in the developing world has meant a 2.5 percent decline in export growth worldwide. The recent OECD Economic Outlook (December 1986) concluded that weakness in demand from the developing world has retarded GNP growth in the industrial world by approximately one percentage point, from the 3 percent projected in 1985 to the 2 percent actually realized for 1986.

CHART XXXI

LATIN AMERICAN EXPORTS

TO MAJOR COUNTRIES



In addition to reducing imports, with adverse consequences for U.S. producers, debtor countries increased their own exports significantly in order to improve their foreign exchange earnings. In contrast to other major industrial countries, the United States has provided a ready market for their expanded exports, with further adverse consequences for U.S. producers. A consequence of vastly increased exports on the part of debtor countries has been greater supplies on the world market, with a concomitant drop in prices. In volume terms, exports from the 15 most heavily indebted countries increased 6.7 percent in 1983 and 9.6 percent in 1984, a rate three to four times higher than the 2.4 percent average from 1968 to 1977. While driving down commodity prices for all producers, the developing countries' exports have not produced sufficient export earnings to permit them to meet their debt service obligations and at the same time achieve needed rates of domestic growth.

The pain of adjustment to the Third World debt problem has been borne disproportionately by some but not all segments of society. Debtor countries have borne the burden of declining national incomes and severe domestic austerity. U.S. farmers and industrial exporters have also borne a heavy burden in terms of a collapse in U.S. export markets to the debtor countries and increased export competition. Taxpayers in the industrial world have borne some of the cost, as World Bank and IMF lending has been increased to help countries cope with the sudden collapse of private lending. However, the financial system as yet has not borne similar burdens as very little debt has been written off, and debt re-schedulings have deferred the date for the repayment of principal without providing any major concessions on the interest rates charged to troubled debtors.

New initiatives which balance better the burdens of adjustment to the debt problem clearly need to be considered.

New Initiatives

It is to the credit of Treasury Secretary James Baker that upon assuming his cabinet position in 1985 he reversed the Administration's policy of ignoring both the debt crisis and the crisis arising from the overvaluation of the dollar. The Baker Plan, first announced in 1985 at the IMF meeting in Seoul, Korea, established as a goal the resumption of growth in debtor nations of both imports and GNP. The Plan recognizes that such a resumption of growth will be impossible without renewed access to external finance, and outlines a program for expanded lending by the World Bank accompanied by renewed lending on the part of private commercial banks, conditioned on the borrower's commitment to carrying out certain domestic reforms.

Nonetheless, the Plan appears to be inadequate in scope and unrealistic in its expectations. It calls for some $9 billion annually in new financial flows over the next three years, but World Bank and other estimates suggest that the needs may be close to $20 billion per year for the next five years. The Plan assumes willingness on the part of commercial banks to resume lending to nations already overburdened with debt service obligations, although such an undertaking on the part of the banks involves obvious risks in a climate of falling commodity prices and uncertain export markets. In fact, nothing resembling the Baker Plan has been put into place for any debtor nation other than Mexico, and the Mexico package has not yet been implemented because a number of U.S. banks continue to resist new lending.

Private debt capital flows on the scale envisioned by the Baker Plan are unlikely to resume until the problem of existing debt burden is addressed. A number of proposals deserve serious analysis. Among these are efforts to encourage repatriation of "flight capital" to debtor countries (to provide a significant source of new finance without creating new foreign exchange debt service obligations); new financial instruments, such as mutual funds (to provide new sources of investment capital without worsening the countries debt service ability); debt-for-equity swaps; and local currency repayment of loans now denominated in foreign currencies.

Proposals for new capital inflows, however, may have to be combined with some new approaches to managing the existing debt. At present, this difficult task can be accomplished only through arduous negotiations between private lending institutions and the debtor governments -- a complex and protracted procedure which carries with it significant financial, economic, political, and diplomatic risks.

An alternative approach may be the creation of a special multilateral institution specifically to address the restructuring of Third World debt. Such an institution could serve to mediate conflicts between debtors and creditors, and work out compromises which would balance the interests of various parties in a common pursuit of renewed world growth. Some portion of the activities of such an intermediary could involve the purchase of sovereign debt at a discount from the banks and passing along the benefits of this discount, and a restructuring of the remaining debt at better terms and rates to the debtor countries. Financing for the intermediary should come largely from countries with strong current account surpluses, since those surpluses are both a threat to the world trading system and the major source of investment capital in the world economy.

c. Monetary Reform

The Problem of Currency Misalignment

Among the causes of the current severe imbalances in national trading accounts, ranging from the U.S. trade deficit of $169 billion to the Japanese trade surplus of $82 billion, is the misalignment of the world's currencies, in particular the overvaluation of the dollar that began in 1982 and is only now being addressed. Since March 1973, when the system of fixed exchange rates was abandoned, the world economy has operated under a system of floating rates, which in theory reflects the underlying flow of goods between countries and permits rapid and orderly adjustment of currency values through free-market exchanges.

The experience of the past 13 years has been very different, however, as exchange rates are increasingly determined more by capital movements than by trade flows. This is in part the result of speculation and, over the longer term, of macroeconomic policy differences between major countries that lead to substantial capital movements in pursuit of interest-rate differentials. While international trade in goods and services now totals approximately $3 trillion annually, foreign exchange transactions in New York, Tokyo, and London are running at about $188 billion daily, or $40 trillion annually.

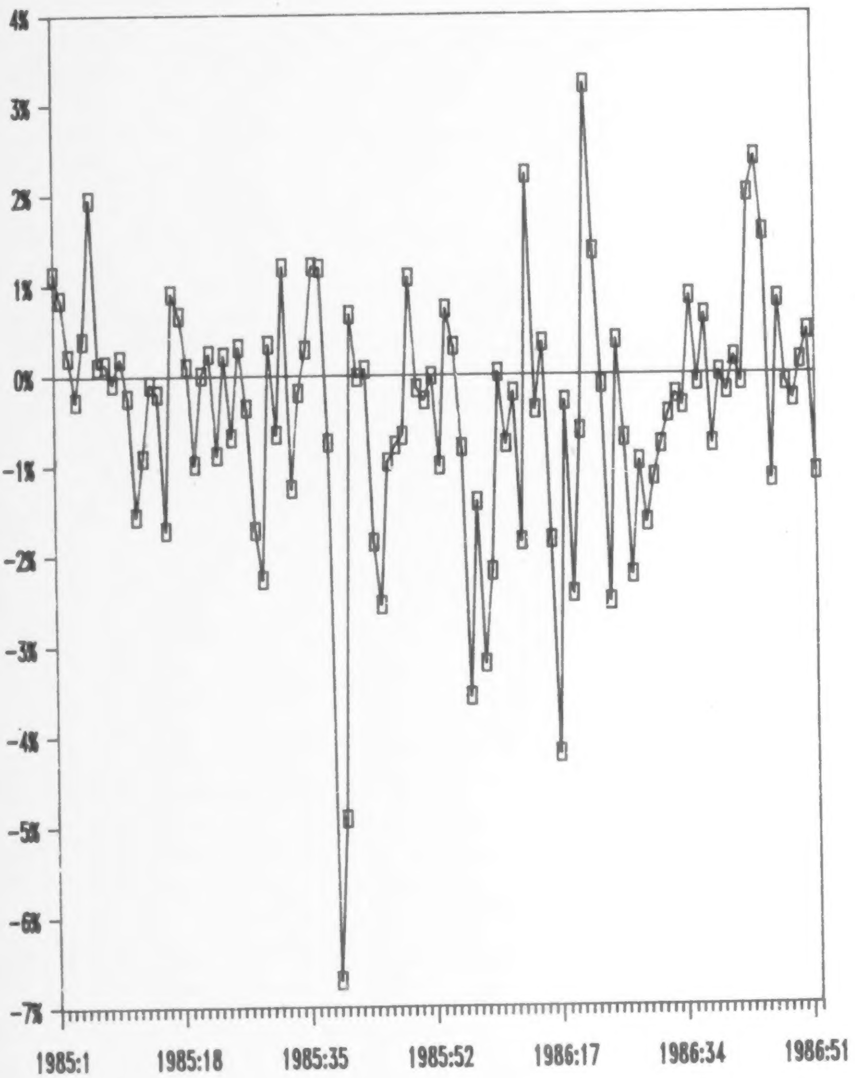
Under these changed conditions, some countries, notably Germany and Japan, have found it possible to run substantial current account surpluses for several years without experiencing a significant appreciation in their currencies, while the value of the dollar has remained very high despite the rapid expansion in the U.S. current account deficit.

Volatility

As Chart XXXII shows, the weekly variation of the dollar with respect to the yen has been substantial, with changes of as much as 7 percent in a single week.

CHART XXXII

WEEKLY CHANGES IN YEN/DOLLAR RATE



Volatility of this magnitude makes forward planning by firms engaged in international commerce difficult. Particularly hard hit are small firms with limited financial expertise and insufficient resources to hedge international goods transactions with financial market options. Concerted intervention in currency markets by the world's major central banks is a reasonable and responsible means to assure more orderly and less volatile markets. The Administration unfortunately resisted such action until very recently, but appears now to be moving in a positive direction.

The Value of the Dollar

While there is general agreement that the overvaluation of the past six years -- to which floating exchange rates and capital market innovation have contributed -- there is little agreement on the degree of overvaluation or the extent to which the dollar must fall in order to produce an exchange rate which will balance U.S. international goods flows over the long term.

Part of the problem lies in determining the value of the dollar. As noted earlier, the Federal Reserve Board index, which is the one most commonly used, is based on historic trade patterns and assigns primary weight to America's industrialized trading partners. The Federal Reserve Board index shows the dollar to have risen 40 percent on a trade-weighted basis from 1980 to its peak in February 1985, and to have fallen 32 percent since then (Chart XXXIII). Broader indices, such as those compiled by Morgan Guaranty Trust and both the Dallas and Atlanta Federal Reserve banks, show a greater rise in the dollar during 1980-1985, and a substantially smaller dollar decline in the period since.

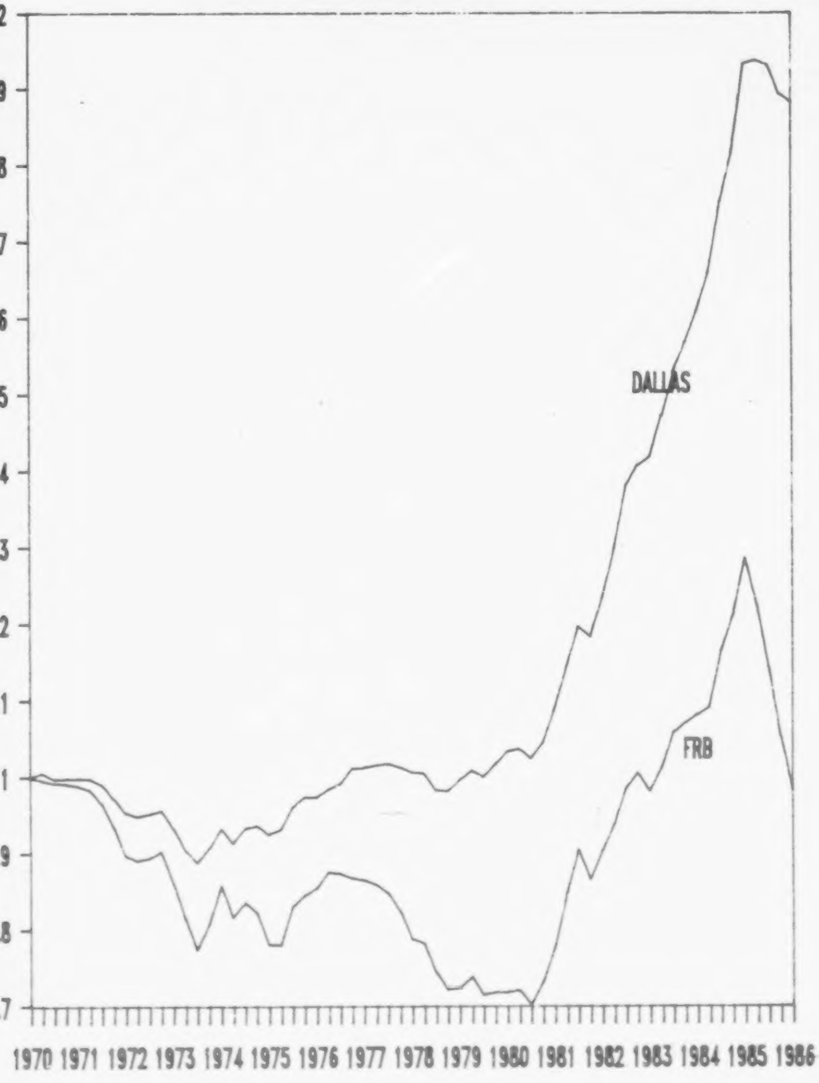
If the broader indices paint a more accurate picture of the true trade-weighted value of the dollar, it would appear that the U.S. dollar remains significantly overvalued against the currencies of many major trading nations.

Examination of bilateral exchange rates between the dollar and selected other currencies clarifies the shortcomings of the Federal Reserve index, as well as the problems associated with floating exchange rates. Changes in the value of the dollar against the currencies of Newly Industrializing Countries (NIC's) have been very small, despite the fact that U.S. bilateral trade deficits with these countries have grown dramatically. In addition, the value of the dollar actually has been rising against the currencies of major U.S. trading partners in Latin America, in part as a result of debt-induced export promotion

CHART XXXIII

TRADE-WEIGHTED DOLLAR INDICES

FRB AND DALLAS FRB



efforts which require currency devaluations in the developing world to stimulate exports and earn foreign exchange for debt service.

The Taiwan Dollar and the Japanese Yen

A brief look at two bilateral exchange rates -- between the U.S. dollar and the Taiwan dollar, and between the U.S. dollar and the yen -- provides some insight into the importance of considering the question of dollar valuation on a country-by-country basis.

In 1980-1985, Taiwan built a substantial bilateral trade surplus with the United States while at the same time the Taiwan dollar fell in value relative to the U.S. dollar, although trade flows would have predicted a rise in the Taiwan dollar as the U.S.-Taiwan bilateral trade deficit grew. Although exchange rate adjustment is evident from mid-1985, the bilateral deficit has continued to rise, suggesting that the Taiwan dollar remains substantially undervalued with respect to the U.S. dollar.

While Secretary Baker is correct in suggesting that exchange rate adjustments alone will not eliminate the U.S. trade deficit, it is not yet clear that the dollar has achieved an appropriate level with respect to the currencies of all major U.S. trading partners.

The substantial impact which both governmental statements and direct central bank intervention in currency markets can have on foreign exchange values is reflected in the recent experience of the dollar against the yen. At the G-5 meeting in September 1985,[2] the United States and Japan agreed that the dollar was overvalued with respect to the yen, and the following day the value of the dollar fell 5 percent. Over the next 12 months it fell an additional 25 percent. When, in October 1986, the two governments issued a joint communique announcing that the dollar was properly aligned against the yen, the two currencies stabilized. Both policy communiques were supported by occasional coordinated central bank intervention in currency markets, producing an orderly decline in the dollar relative to the yen.

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[2] G-5 is a consultative group comprised of finance ministers of the five major industrialized countries -- the United States, the United Kingdom, France, Germany, and Japan. The G-7 group is comprised of the G-5 plus representatives of the next two industrialized nations -- Italy and Canada.

CHART XXXIV

TAIWAN'S TRADE SURPLUS WITH U.S.

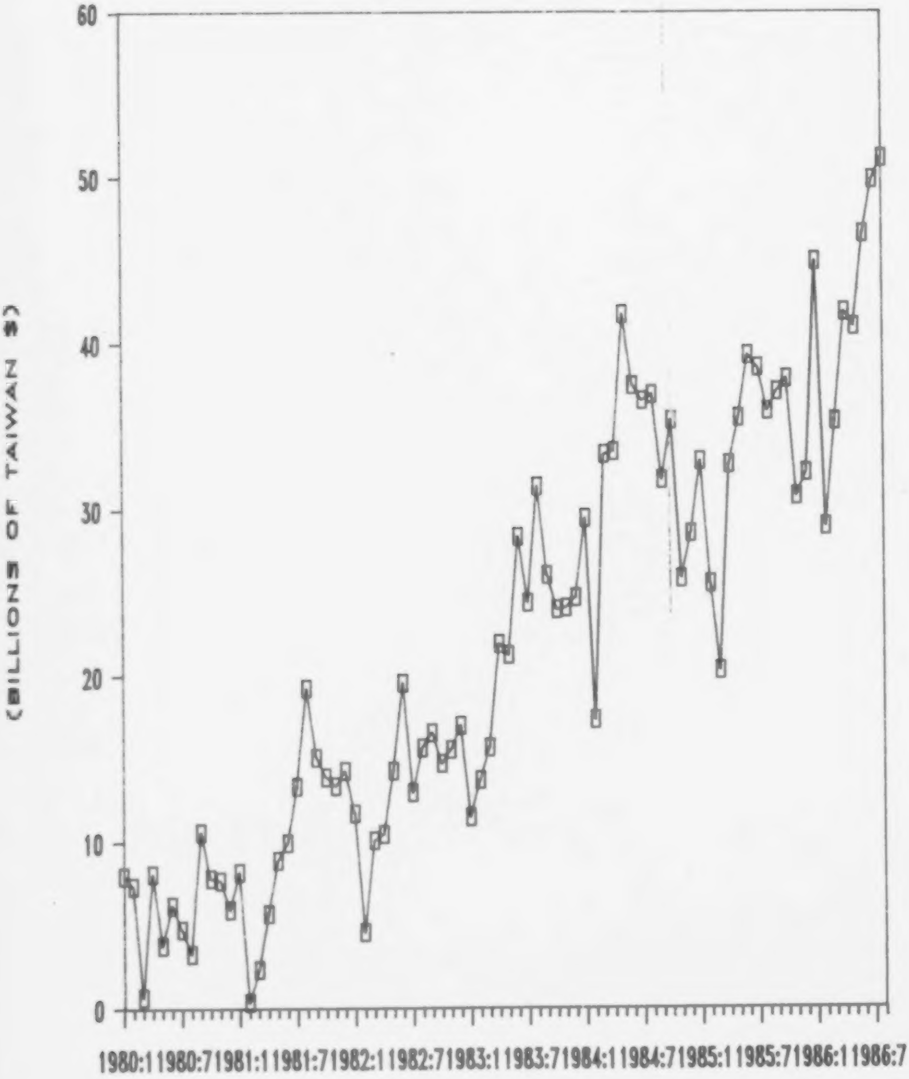
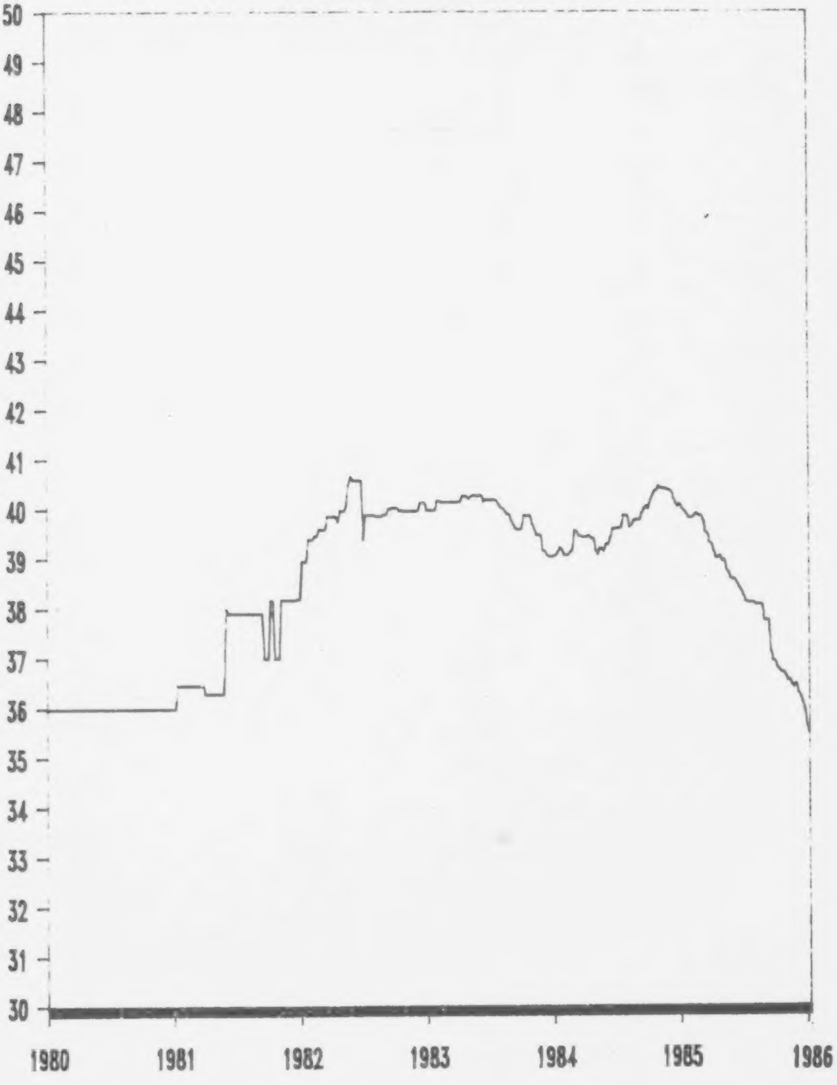


CHART XXXV

TAIWAN/U.S. EXCHANGE RATE

Taiwan Dollars Per U.S. Dollar



In the final months of 1986, however, the agreement between the United States and Japan on the appropriate value of the dollar appeared to have broken down. Officials at the Treasury and the Federal Reserve were seen as having substantially different views on the future course of the dollar, and the foreign exchange markets became highly uncertain about both currencies.

This uncertainty created a need for more visible signs of policy agreement among the major governments on exchange rates, and the G-5 ministers then met in Paris in February 1987, producing an apparent agreement to stabilize exchange rates and to promote faster growth in both Germany and Japan. Some uncertainty surrounds the details of the agreement, particularly with respect to the commitments by various central banks to intervene in support of existing exchange rates. But despite this uncertainty, the recent Paris agreements represent a step forward in increasing the coordination of monetary and fiscal policy among major nations in pursuit of more realistic and stable exchange rates.

The experience with the yen suggests the desirability and efficacy of coordinated policy action and improved management of other bilateral exchange rates, especially in cases of countries enjoying large bilateral and multilateral trade surpluses whose currencies have not moved significantly. The Taiwan dollar, for example, is insulated from normal market adjustment mechanisms by deliberate government policies with respect to capital controls and central bank reserves. Taiwan's central bank currently holds $48 billion in U.S. dollar reserves, more than the central bank reserves of any industrialized country.

Apart from such targeted initiatives, there is need for further examination of the entire international monetary system, the role of capital mobility in the exchange rate system, and the tensions caused by having the U.S. dollar serve as the central bank reserve currency. The complexity of the problems posed by the international monetary system should not deter the search for a solution.

CONCLUSIONS

1. Much of U.S. trade law has been overtaken by a rapidly changing and increasingly competitive world economy. It is time for a careful and thorough revision of existing trade laws to provide a more effective and equitable means for assuring open foreign markets and expanding world trade, and for facilitating the adjustment of U.S. firms to the new challenge of international competition.

2. A new round of negotiations is underway in the GATT, the basic international structure for setting the rules of trade. In recent years, GATT's scope has proved too narrow to meet changing conditions and its effectiveness has declined, while at the same time strains in the international trading system have intensified. The Administration should therefore move into the negotiations with the clear objective of making the GATT a major guarantor of open markets and expanding world trade. Toward this end, the Administration should expand its current limited agenda for the GATT round and assure that the United States will be represented by skillful and experienced negotiators fully backed by the Administration.

3. Although the exchange value of the dollar is a major determinant of the U.S. international trade position, its critical role was ignored or minimized by the Administration for too long. Beginning this year, the Administration should submit semiannually to the Congress an International Monetary Policy Report outlining the steps being taken by the Administration to secure both stability and proper alignment of international currency values.

4. Stabilization of international exchange rates will require a higher degree of coordination in the domestic fiscal and monetary policies of the major trading nations than has been evident in the past few years. Securing this coordination should be a major goal of economic policy, and an important objective for the Administration in its diplomatic dealings with U.S. allies.

5. Under the prevailing system of floating exchange rates, capital flows are critically important in determining currency values and in influencing the flow of goods and services between nations. Data currently available about different types of capital movements are inadequate and unsystematic, collected by a variety of different agencies on the basis of widely varying assumptions and methodologies. To assure better information on international capital flows, the Administration should review existing capital flow data and develop plans for comprehensive and coordinated data collection and publication.

6. Orderly adjustment in the world economy to a declining U.S. trade deficit requires strong demand growth abroad. This is particularly true in the developing world, where in many countries growth is hampered by excessive debt burdens and a large transfer of financial resources from debtor to creditor countries. Administration initiatives to promote growth in the developing world, while a step in the right direction, have been insufficient. With the objective of assuring a resumption in world economic growth, policies must be developed both to reduce the outflow of funds from the developing world and to increase the inflow of new capital, and new methods should be designed to balance the needs of creditors and debtors, and expand the role of surplus countries in financing world development.

C. PRODUCTIVITY AND RESOURCE UTILIZATION

1. PRODUCTIVITY

In the postwar period, both the rate of productivity growth and the share of total output growth due to gains in productivity have declined consistently. Parallel to the decline in the U.S. productivity growth rate, and largely caused by it, has been the drop in the average annual compound rate of increase in real hourly compensation: 2.9 percent in 1947-1965, 2.2 percent in 1965-1973, and 0.2 percent in 1973-1986.

TABLE VI

GROWTH OF OUTPUT, PRODUCTIVITY, AND HOURS WORKED, IN THE NONFARM BUSINESS SECTOR, 1947-1986

Period	Output	Productivity	Hours Worked	Percentage of Growth in Total Output Due to Productivity Gains
1947-1965	3.9%	2.7%	1.1%	71%
1965-1973	3.7	1.8	1.8	50
1973-1986	2.4	0.7	1.7	29

Source: Bureau of Labor Statistics

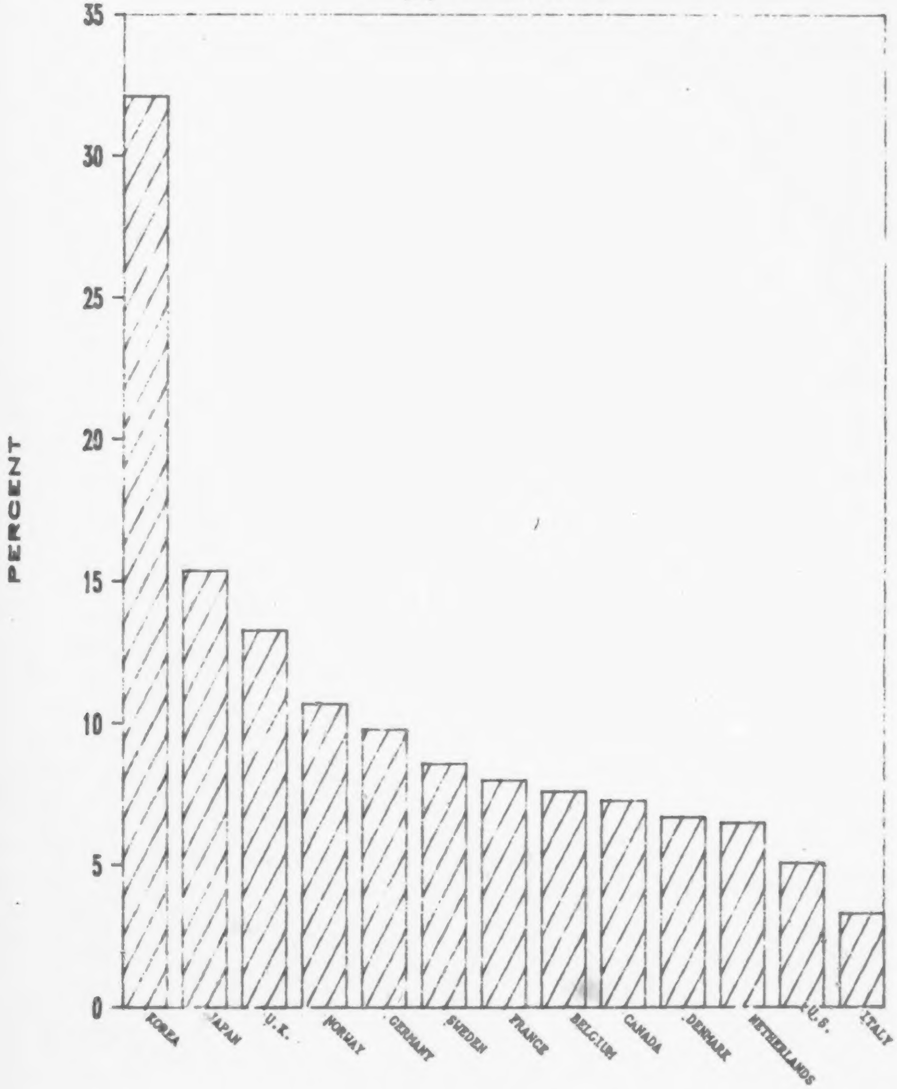
a. Productivity And International Competition

The United States today lives in a changed world economic environment and can no longer ignore international trends, standards, and conditions. Where productivity is concerned, U.S. increases fall far short of accomplishments in other countries. In 1980-1985, overall productivity rose more rapidly in 11 of the 12 countries studied by the BLS than in the United States.

CHART XXXVI

GROWTH IN GROSS DOMESTIC PRODUCT

Per Employed Person, 1980-85



The Japanese case is worth noting. In 1950, the value of real gross domestic product (GDP) produced by the average Japanese worker was only one-sixth the value of the production of the average American worker. By 1960, this ratio had risen to one-fourth; by 1970, to one-half; by 1980, to more than two-thirds; and by 1985, to three-fourths. The tremendous growth in productivity explains how Japan, with the world's seventh largest population and virtually no natural resources, has developed into the world's second largest economy. If this trend continues, the average Japanese worker will be more productive than his American counterpart by the end of the century, a development which has already occurred in certain industries.

Since 1980, wage increases in manufacturing have been low, while productivity growth has been much stronger than in the economy as a whole. The moderation achieved in unit labor costs has been more than offset, however, by the sharp rise in the value of the dollar. The Council of Economic Advisers estimates that between 1980 and 1985 average U.S. unit labor costs fell 4 percent relative to foreign unit labor costs, without adjusting for exchange rates. But the sharp rise in the value of the dollar raised U.S. labor costs by 39 percent on a dollar basis relative to foreign unit labor cost.

In any effort to reduce the trade deficit, the value of the dollar will be an important factor. Over time, a more realistic valuation will make U.S. products more competitive and contribute to reducing the deficit, but adjustment of currency exchange rates alone will not solve the deficit problem. If productivity cannot be improved sufficiently to assure U.S. competitiveness, both abroad and at home, then the United States will be forced to resort to alternative measures to bring down the deficit that will undermine the U.S. standard of living -- using recession to restrict U.S. demand as a means of discouraging imports; lowering wages in an effort to make the United States more competitive; or countenancing the radical devaluation of the dollar.

b. Sources of Productivity Growth -- Capital Formation, Education, and R&D

Productivity growth rates rose in 1983 and 1984, consistent with business cycle trends in which productivity generally rises rapidly in the early stages of a recovery as output rises without major increases in the labor force. Since that time, however, the growth rate has been much lower -- 0.5 percent in 1985 and 0.7 percent in 1986 -- and productivity actually fell at a 1 percent rate in the second half of 1986.

If steady improvement in productivity is to be assured in the long term, basic questions about the formation and use of capital resources, and about the skills, competence, and motivation of the labor force, will have to be addressed. The CEA Report cites "four important developments" -- demographic trends, recent energy price declines, R&D expenditures, and tax revision -- which are "likely to contribute to stronger long-term productivity growth." The CEA analysis requires brief comment.

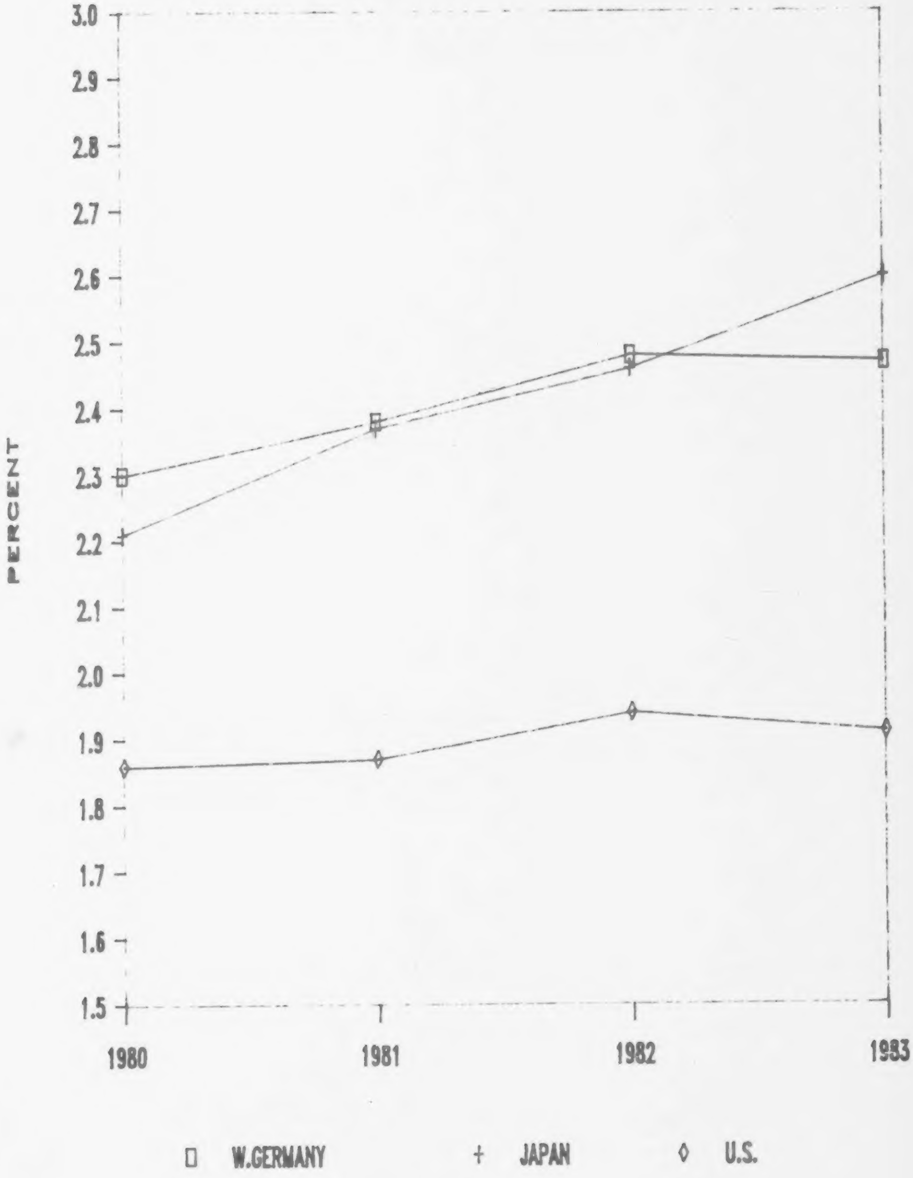
First, the CEA places the longer term developments in a very narrow focus. It is true that over the next 15 years the labor force will grow older and more experienced, and that productivity generally increases with age and experience. The potential for significant improvement in productivity will be limited, however, by the extent to which the working population is undereducated, unskilled, and untrained -- for example, functionally illiterate 40 year-olds are likely to be only marginally more productive than functionally illiterate 25 year-olds. While the CEA acknowledges the critical role "government" has to play in education, the role of the Federal Government goes unmentioned, consistent with pending Administration proposals to reduce Federal elementary and secondary school programs and at the post-secondary level to terminate the work-study program, radically restructure the Guaranteed Student Loan program, and further reduce existing grant programs.

Second, where energy prices are concerned, sustained improvement in productivity will depend on future energy prices and not simply on those that occurred in 1986. The Producer Price Index (PPI) for finished energy goods rose 10 percent in January of this year, and virtually all forecasts, including the CEA's, foresee additional price increases.

Third, investment in R&D is an important factor in promoting technological progress and productivity growth. While Federal R&D expenditures have increased nearly 60 percent in 1981-1986, the emphasis has been overwhelmingly on the military, which has more than doubled while nondefense R&D has increased less than 6 percent. As a result, the defense-nondefense balance in the Federal R&D program has shifted from roughly 50/50 to well above 2/1. Furthermore, as a percentage of GNP, the total U.S. commitment to nondefense R&D (both private and public) falls significantly short of West Germany and Japan, and has grown at a much slower rate.

CHART XXXVII

NON-DEFENSE R&D AS A PERCENT OF GNP



Fourth, the CEA cites the recent tax revision, indicating that any "small negative effect on the long-run capital stock" will be accompanied by a reduction "in distortions affecting the distribution of capital among productive activities." While in testimony before the Committee CEA Chairman Sprinkel said that the short-term adverse effects of the tax changes "should end in 1987," most private forecasters believe they are more likely to begin in 1987. Economists differ significantly over whether the long-term benefits will exceed the short-term costs, suggesting that at this time the consequences of tax revision for productivity growth cannot be assumed with any certainty.

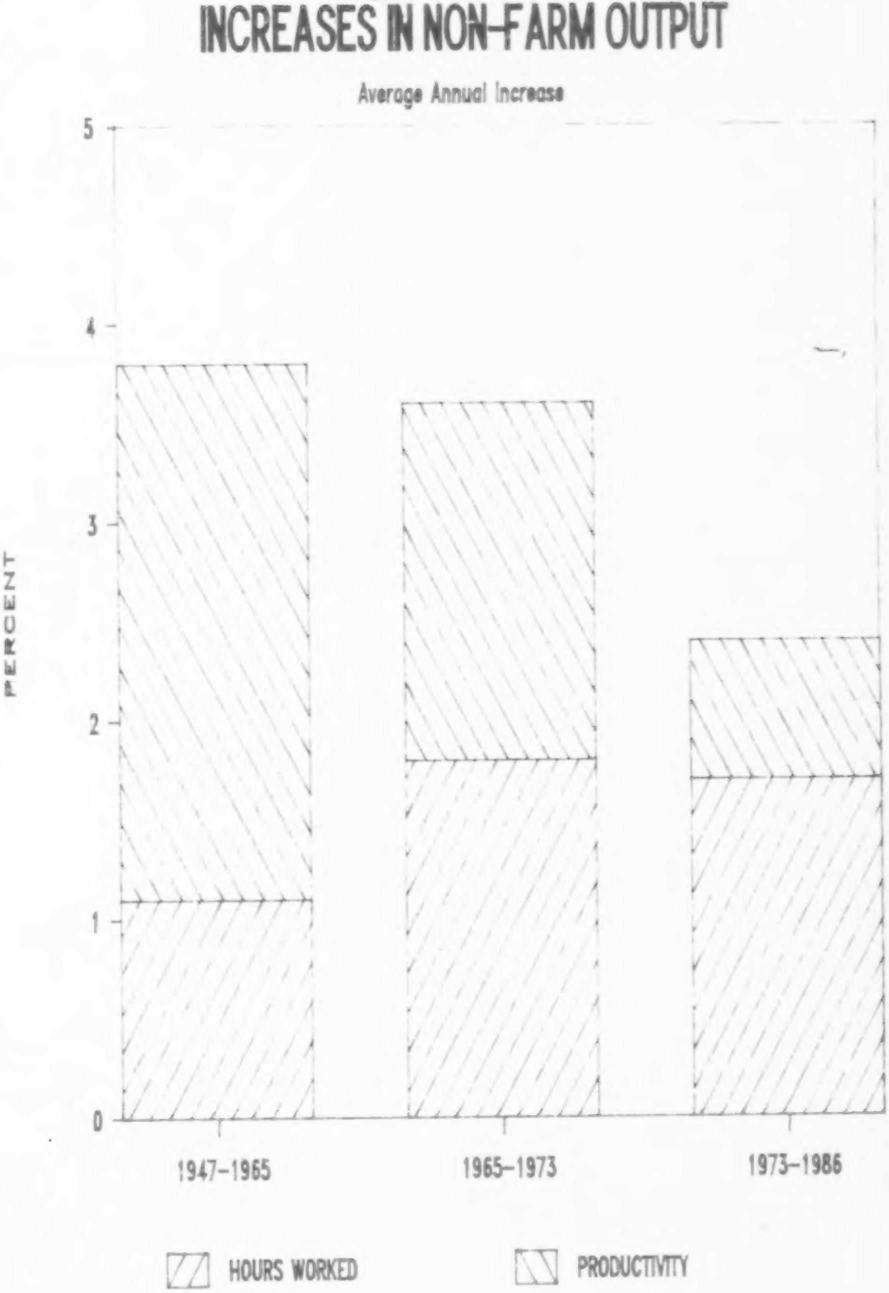
c. Outlook for Productivity

Keeping in mind that Administration productivity forecasts have tended in the past to be overly optimistic, the plausibility of the current forecast can be examined by comparing it with other current estimates.

In testimony before the Committee, Federal Reserve Chairman Volcker said that "unhappily there is no solid evidence" that productivity will "increase above the recent trend of 1 percent or so." DRI and Wharton Econometric Forecasting Associates both see productivity rising at an average annual rate of 1.3 percent over this period. Chase Econometrics is slightly more optimistic at 1.5 percent, but still below the Administration's projection of 1.9 percent. It seems that this year, as in the past, the official six-year forecast of average productivity growth rate is probably too high by at least a half of a percentage point and perhaps as much as one percentage point.

Improving productivity will require particular attention to the service sector, where a growing percentage of the working population is employed. The CEA Report takes note of this problem, which reflects the declining share of jobs in goods-producing industries, especially manufacturing, and a concomitant increase in service-sector employment. Over the 1973-1985 period, hours worked in manufacturing, agriculture, transportation, and public utilities -- jobs with good productivity growth, i.e., 2.2 percent annually -- declined markedly, while hours worked in wholesale and retail trade and other service-sector -- jobs with very low productivity growth, i.e., 0.4 percent annually -- increased to account for 48 percent of total hours worked. The challenge of improving productivity in the service sector is complicated by the fact that output per hour is difficult to measure.

CHART XXXVIII



2. U.S. CAPITAL RESOURCES

a. Savings/Investment

Any economy which seeks to grow and develop must save a significant portion of current output and apply those savings to investments which will help expand output in the future. As a general rule, the greater the savings and the more productive the investment, the greater the long-run growth potential of the economy.

Historically, the United States has had a savings rate quite low in comparison to that of other countries. This low savings rate traditionally has not been a drag on U.S. economic growth. For most of this century, the U.S. economy generated more savings than were needed to meet the demands of businesses, households, and government for borrowed funds. The United States used some of this excess savings to finance a portion of the investment needs of a large number of foreign countries.

During the 1970's, however, the demand for savings began to press upon the available supply of savings. Borrowing, particularly by consumers and government to support current consumption, increased significantly, and concerns began to be voiced that these consumption-related borrowings would "crowd out" business investment. In an environment of increased borrowing, America's low savings rate became an important issue in the economic debate.

Increasing the savings rate was a major goal of "supply-side" economics, a key justification for the 1981 tax cuts, and a centerpiece of the Administration's 1981 economic program. Nonetheless, recent policies pursued appear to have worsened the savings rate and expanded the pressures of borrowing on America's shrinking pool of savings. To balance the increased demands of borrowers with the supply of funds by domestic savers, the United States has borrowed heavily from savers elsewhere in the world.

Under these new circumstances, there is growing concern that the low U.S. rate of domestic savings is no longer compatible with strong long-term growth in the economy. The rapid increase in consumption-related borrowing means that needed long-term investment in the economy can be financed only by borrowing savings from abroad. While this external borrowing makes it possible to sustain an illusion of rising living standards in the present, such borrowings constitute a claim against future U.S. output and the future earnings of U.S. producers.

The growing gap between borrowing and saving in the U.S. economy will need to be reduced in the years ahead if the economy is to achieve its maximum long-run growth potential. Such adjustment requires both an increase in savings and a decrease in borrowing to support current consumption or wasteful speculation.

U.S. Savings Rates: An International Comparison

Administration policies have not improved the savings performance of the United States compared to that of the other G-7 countries. In 1984, the last year for which comparable international data are available, gross savings were still a smaller percentage of GDP in the United States (17 percent) than in any other major industrial country (Chart XXXIX).

Gross savings, however, may not be the best index of the resources available to increase a country's capital stock. A portion of every nation's gross savings must be devoted to replacing worn out or obsolete capital, but while replacement of depreciated equipment is essential, such capital consumption expenditures simply prevent the stock of plant and equipment from shrinking. For this reason, the amount of savings remaining after depreciated capital has been replaced -- net savings -- may be a better measure of comparative savings and investment rates. According to this measure, the United States lags even further behind its major industrial competitors.

Not only are gross savings a smaller percentage of GDP in the United States than in other OECD countries, but a greater percentage of U.S. gross savings are devoted to replacing worn out capital (Chart XL). In the United States, approximately 75 percent of gross savings is used to meet depreciation expenses; only 25 percent is available for expanding the capital stock. In Japan, by comparison, less than half the gross savings are used to replace worn out capital. In the other OECD countries, the comparable figure is between 57 percent and 63 percent.

CHART XXXIX

GROSS SAVINGS AS A PERCENT OF GDP, 1984

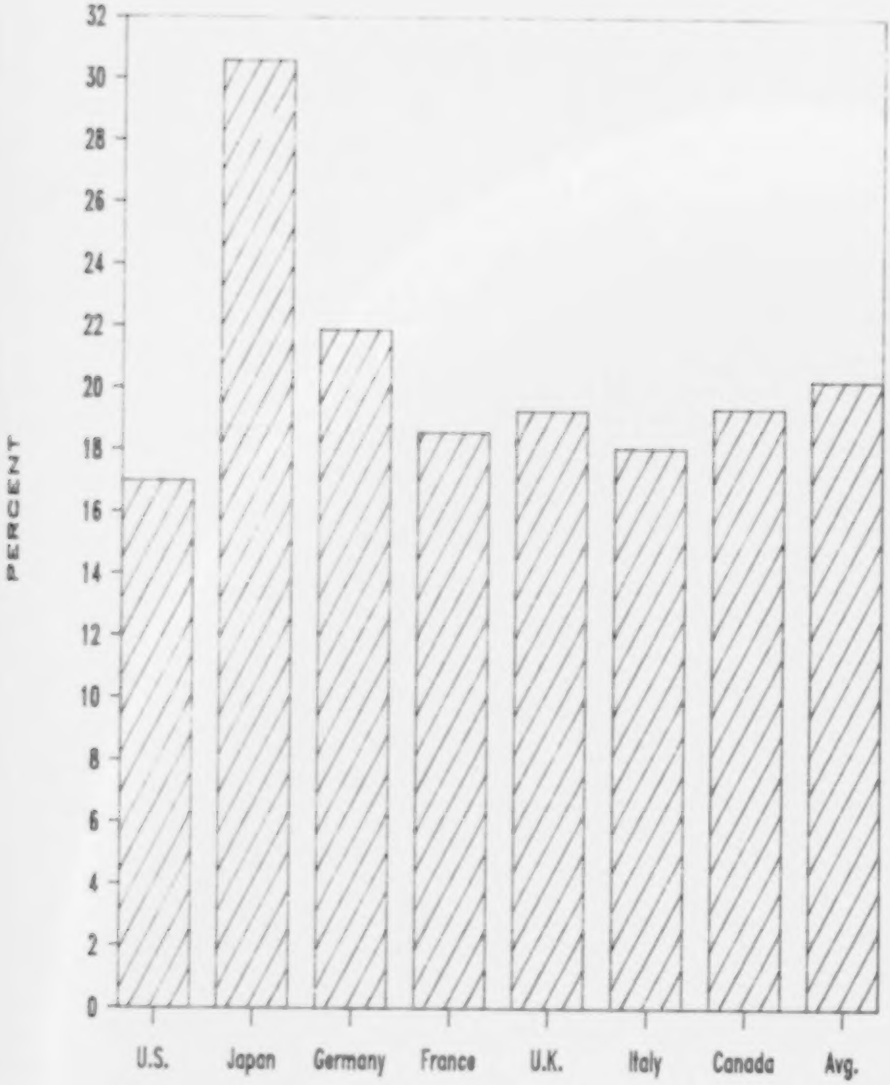
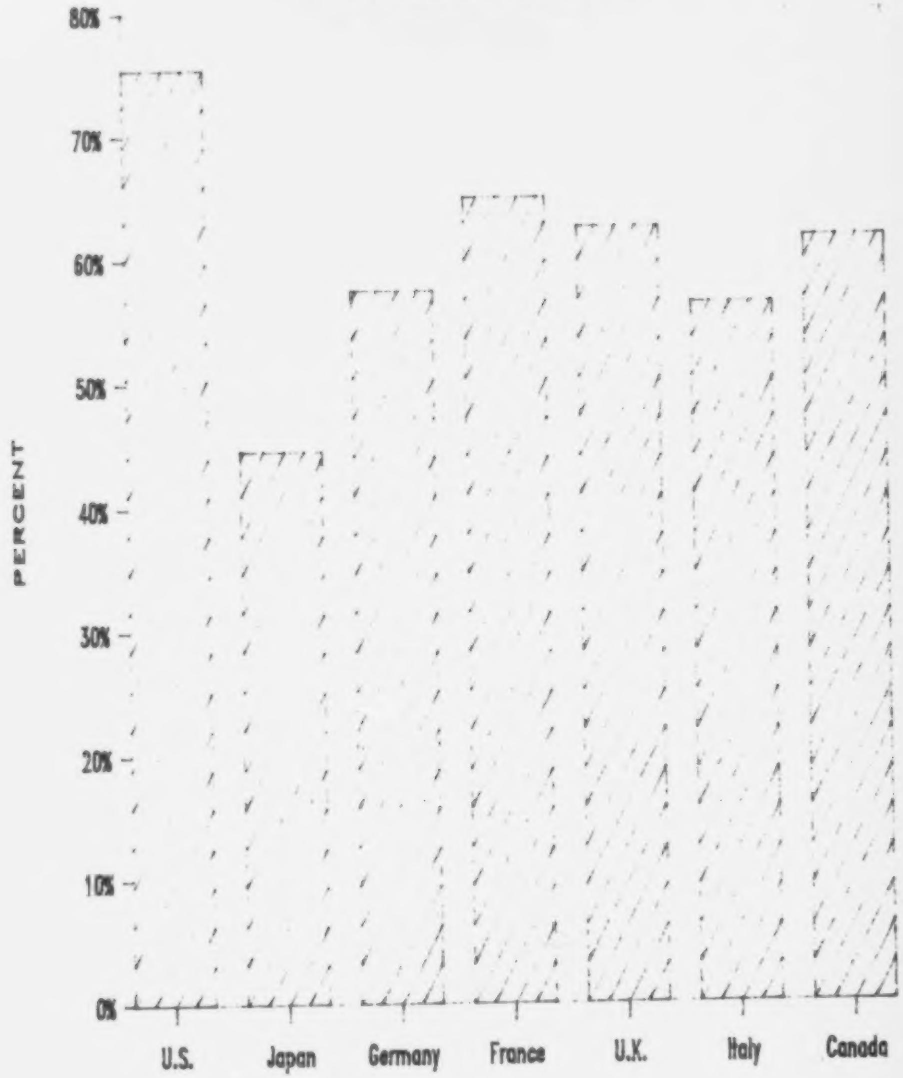


CHART XL

DEPRECIATION AS A PERCENT

OF GROSS SAVINGS, 1984



Because the United States saves less than other OECD nations and then devotes a larger portion of its savings to maintaining the existing capital stock, the United States lags behind other countries in terms of the savings (measured as a share of GDP) that are available to expand the existing stock of capital (Chart XLI). In the United States, net savings amount to only 4 percent of GDP. In Japan, the share of GDP devoted to net savings is more than four times greater. In the other G-7 countries, net savings are approximately twice as large as in the United States.

Trends in Savings

To determine why the United States lags so far behind its main industrial competitors, it is necessary first to determine which economic sectors are actually doing the saving as well as how those savings are invested.

One of the most commonly used indices of U.S. savings is the personal savings rate -- the amount of disposable, or after-tax, personal income remaining after deducting all household expenditures for consumer goods, monthly housing payments, and other debt service costs such as credit card payments and auto loans. Measured in terms of personal savings, U.S. savings rates appear to have declined over the past five years. Between 1981 and 1986, disposable personal income increased by approximately $850 billion while personal savings declined by $43 billion, falling from $159 billion in 1981 to $116 billion in 1986. Thus, the personal savings rate declined from 7.5 percent of disposable personal income in 1981 to 6.3 percent in 1984 to only 3.9 percent in 1986. Not only was this the lowest personal savings rate since 1949 but, as Federal Reserve Chairman Volcker noted recently, for the first time in decades, "the net influx of foreign capital appears to have exceeded all the savings generated by individuals in the United States."

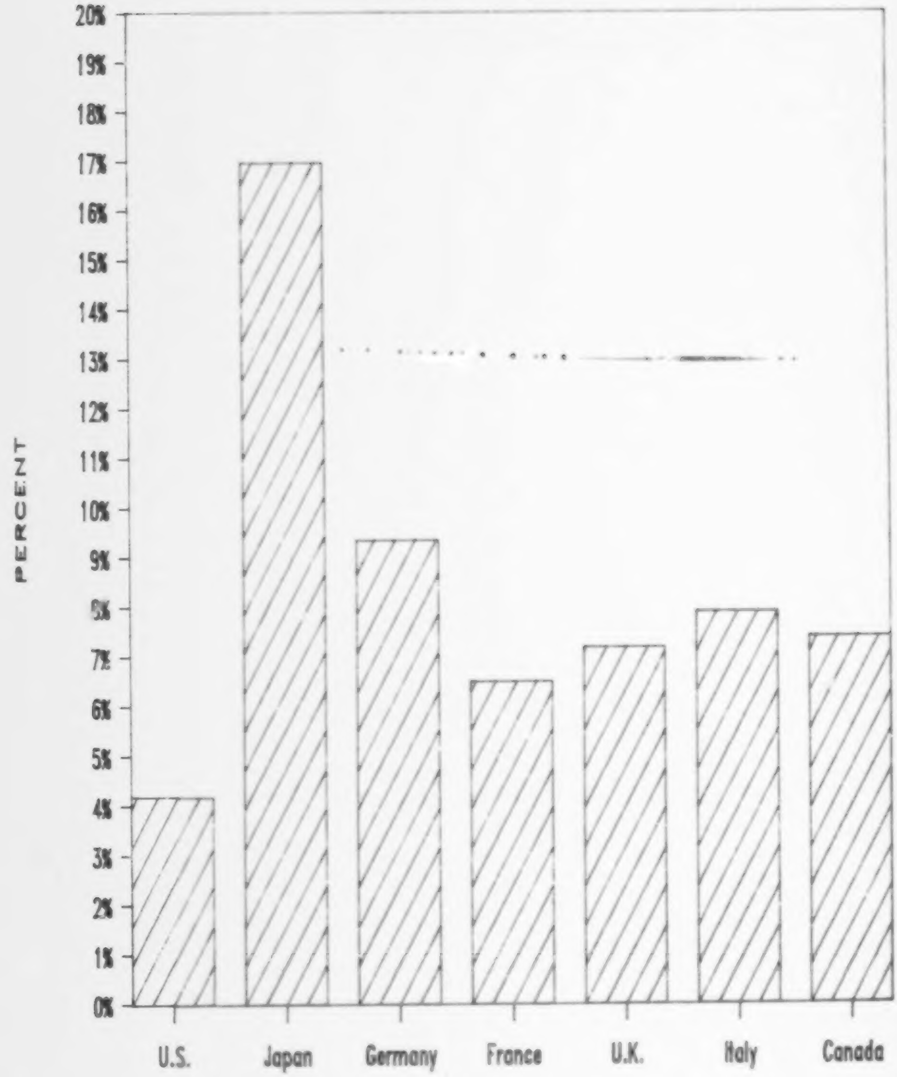
Besides falling to the lowest level in 37 years, the U.S. personal savings rate was also the lowest of any major industrial country. In 1984, for example, personal savings rates in the other G-7 countries ranged from a low of 12.2 percent in the United Kingdom to a high of 23 percent in Italy. At 16 percent of disposable personal income, Japan's personal savings rate was the second highest among the G-7 and approximately 10 percentage points above the U.S. rate.

Personal savings data, while useful, do not offer the most complete and informative portrait of an economy's savings performance. First, personal savings are only one component of the total savings pool. And second, personal savings do not indicate how efficiently an economy is investing its savings.

CHART XLI

NET SAVINGS AS A PERCENT

OF GROSS SAVINGS, 1984



A more informative measure is the Federal Reserve Board's gross savings statistic -- total savings in household, business, government, and foreign sectors before that sector's own capital expenditures are deducted. A second important statistic employed in the Federal Reserve Board's Flow of Funds analysis is "net financial investment," which measures the difference between each sector's gross savings and its capital expenditures and is an index of how much of that sector's gross savings are available for use by the other sectors.

The household sector has always been the largest source of gross savings. More importantly, despite the widely discussed decline in personal savings, gross household savings increased by approximately $180 billion between 1981 and the end of the second quarter of 1986. Household net financial investment, however, increased by only $12 billion. This suggests that even though households were increasing their gross savings they were also increasing their consumption of capital goods such as houses and automobiles. In a dramatic shift from recent years, only a relatively small portion of the additional household gross savings was available to finance the investment needs of the other domestic sectors.

As recently as 1981, household net financial investment was sufficient to finance both the savings deficit of the business sector and the U.S. Government budget deficit. Not only were foreign savings not needed, but the United States had a surplus of domestic savings which it lent to foreign borrowers. In 1986, by comparison, the dramatic rise in U.S. Government budget deficits, coupled with a modest increase in household net financial investment, created a domestic savings deficit. To fill that gap, the United States began to draw on foreign savings.

Trends in Borrowing

Resorting to foreign savings was not the only available option. With a more balanced approach, the United States could have tried either to increase its gross savings or reduce its borrowing. Supply-side policies were intended to generate additional domestic savings, but the same policies also gave rise to an unprecedented wave of borrowing. While gross household and business savings did increase by approximately $28 billion, those additional savings fell far short of the amount needed to finance the unprecedented demand for loanable funds, which followed in the wake of supply-side policies.

The magnitude and origin of the economy's recent borrowing can be illustrated by examining the ratio of domestic nonfinancial debt to GNP. Prior to 1982, domestic nonfinancial debt -- Federal Government debt plus private-sector debt -- grew at about the same pace as GNP. Consequently, the ratio of domestic nonfinancial debt to GNP stayed at a remarkably constant level of approximately 1.40 (Chart XLII). The ratio varied only from a peak of 1.45 in 1963 and 1964, to a low of 1.39 in 1969.

Although the overall ratio remained steady between 1962 and 1981, the composition of the outstanding debt underwent dramatic changes (Chart XLIII and Chart XLIV). Despite Federal budget deficits in 19 of those 20 years, the ratio of Federal Government debt to GNP declined steadily. The Federal Government, in effect, made room in the credit markets for private-sector investment, home mortgages, consumer credit, and lending to farmers and small businesses. The ratio of private-sector debt to GNP rose steadily between 1962 and 1981, offsetting the decline in the ratio of Federal debt to GNP and keeping the overall ratio constant.

Beginning in 1981, the ratio of total domestic nonfinancial debt to GNP increased sharply, rising from 1.41:1 in 1981 to 1.72:1 by the second quarter of 1986. In contrast to pre-1981 trends, when a decrease in one component offset an increase in another, the recent surge has occurred simultaneously in the Federal Government, household, and nonfinancial business sectors (Table VII).

Federal Government Borrowing

U.S. Government debt more than doubled from $830 billion in 1981 to $1,706 billion at the end of the second quarter of 1986. This represents an annual increase in outstanding Federal debt of close to 16 percent, far higher than the 2 percent rate experienced during the 1960's and the 9 percent rate of the 1970's. Not surprisingly, the annual pace of Federal Government borrowing rose from $87 billion in 1981 to a peak of $223 billion in 1985. By the middle of 1986, it had fallen to approximately $200 billion annually -- a rate about double the 1981 level.

Interest payments on the U.S. Government debt also doubled during this period, rising from $95.5 billion in FY 1981 to $190.1 billion in FY 1986. In its most recent budget, the Administration projects that interest payments on the public debt will continue rising through 1991, albeit at a more moderate pace. By FY 1991, interest payments are projected to be $209 billion, or 10 percent above the current level.

CHART XLII

TOTAL DEBT AS A PERCENT OF GNP

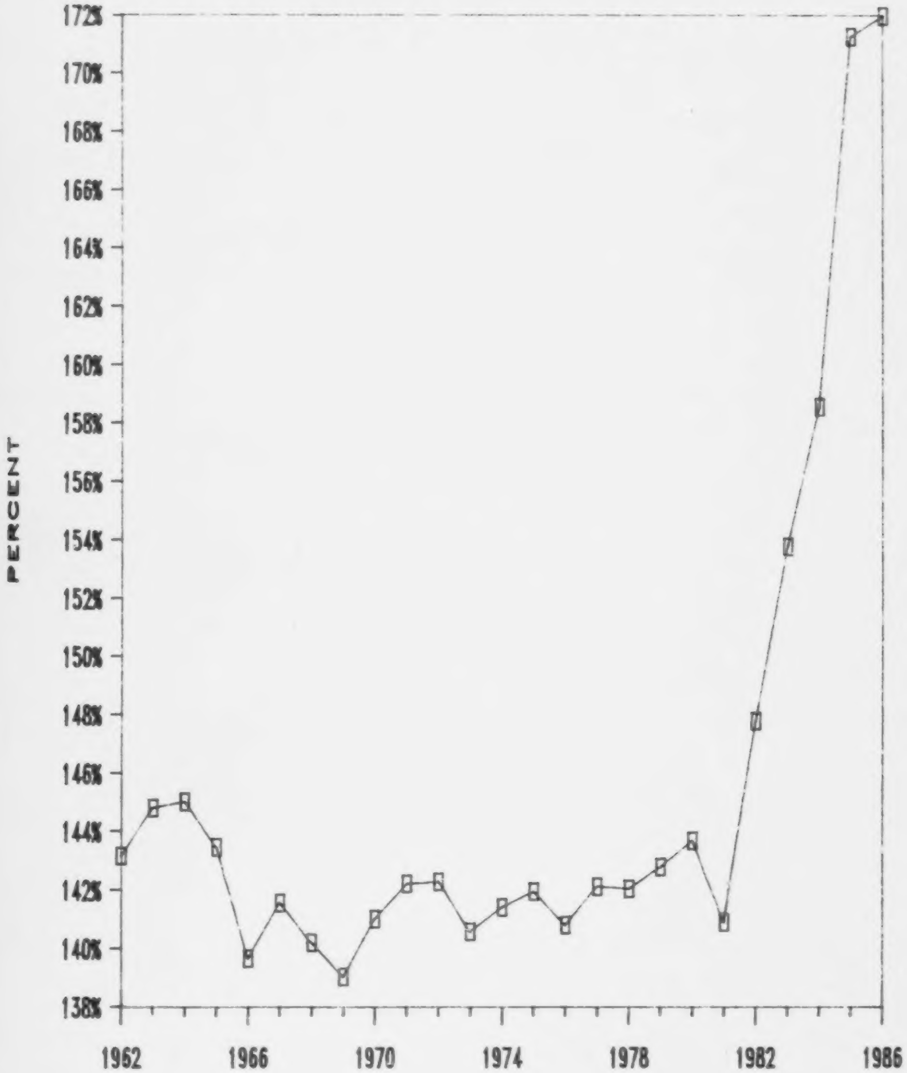


CHART XLVII

FEDERAL DEBT AS A PERCENT OF GNP

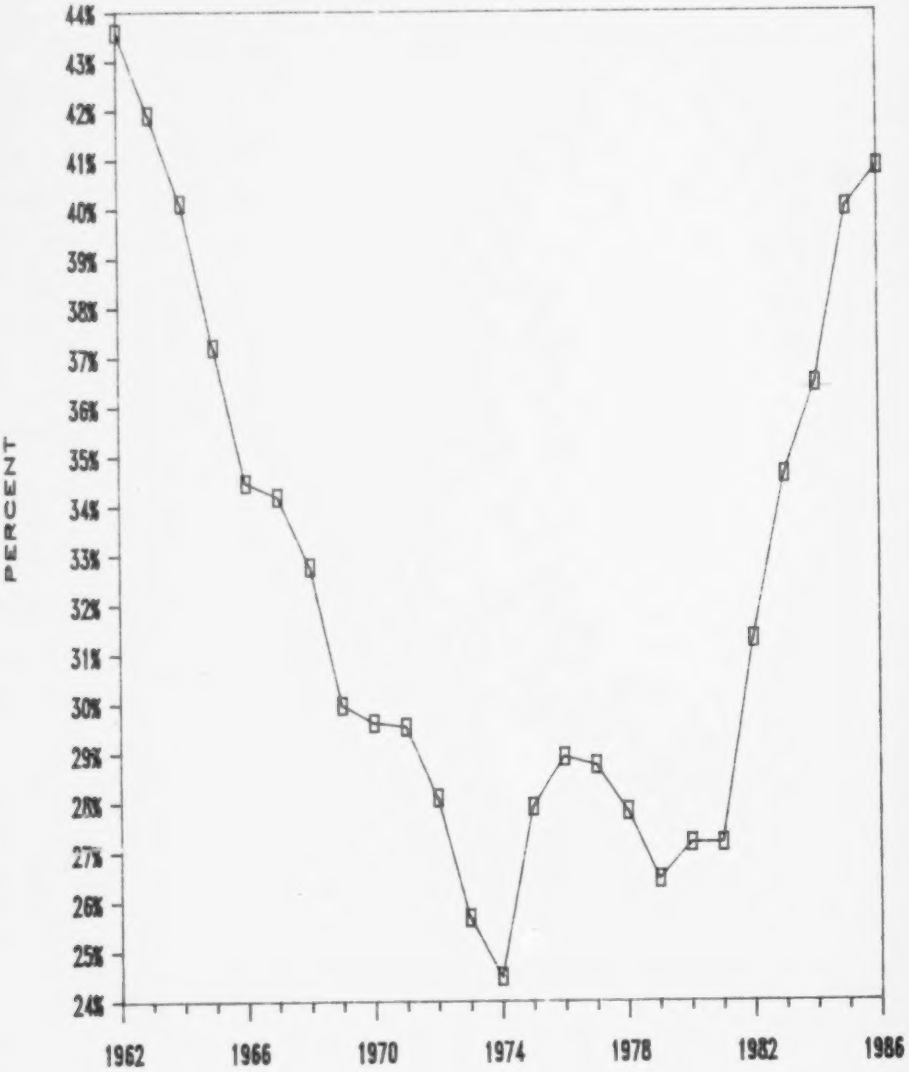


CHART XLIV

PRIVATE DEBT AS A PERCENT OF GNP

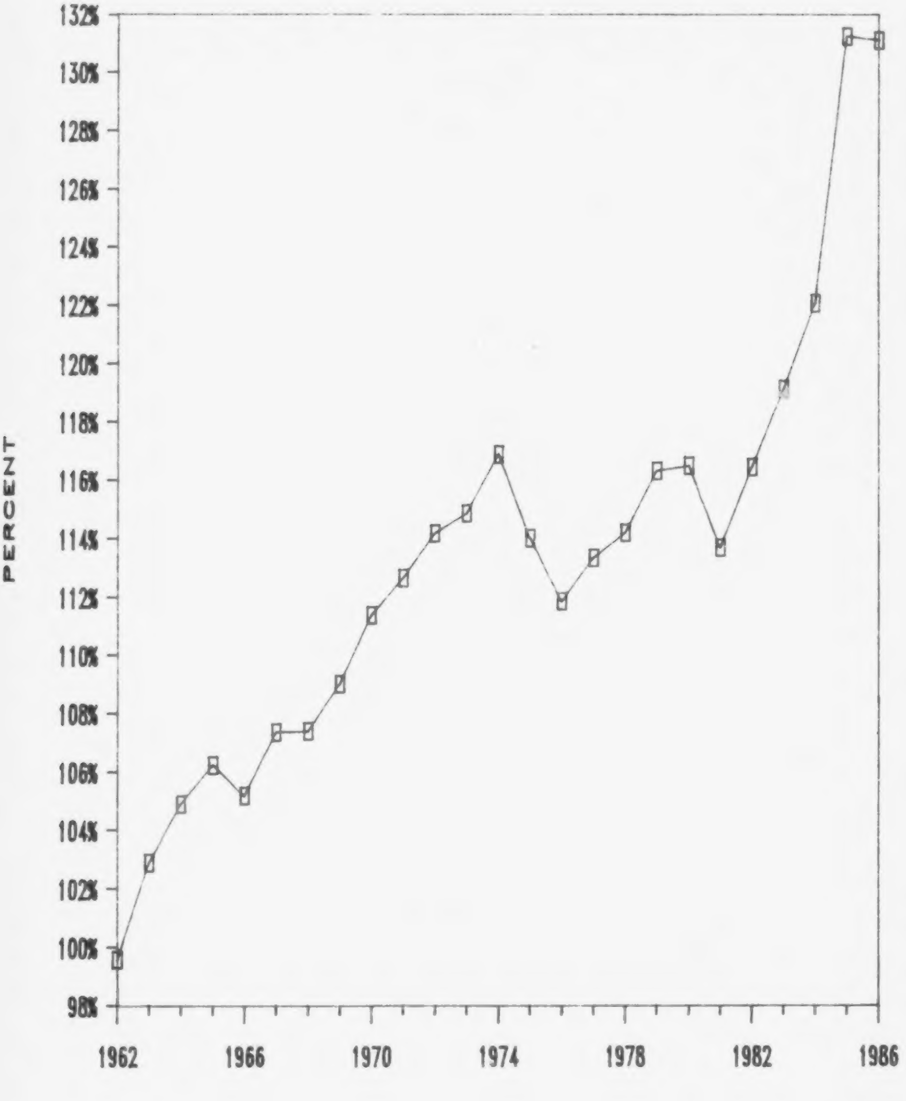


TABLE VII: DOMESTIC NONFINANCIAL DEBT AND GNP (ABSOLUTE VALUES AND PERCENT OF GNP)

	GNP	TOTAL DOMESTIC NONFINANCIAL (1)=(2)+(5)	PRIVATE NONFINANCIAL* (2)=(3)+(4)	HOUSEHOLDS (3)	BUSINESS (4)	FEDERAL GOVERNMENT (5)
1981	3058.3	4301.2	3471.1	1577.7	1591.3	830.1
1982	3166.0	4679.1	3687.7	1659.8	1704.3	991.4
1983	3405.8	5230.6	4052.6	1847.5	1847.5	1177.9
1984	3765.0	5985.4	4608.7	2082.0	2141.6	1376.8
1985	3998.0	6851.0	5250.6	2369.7	2388.0	1600.4
1986	4175.6	7204.1	5498.1	2482.0	2503.9	1706.0
1981		1.41	1.13	.52	.52	.27
1982		1.48	1.16	.52	.54	.31
1983		1.54	1.19	.54	.54	.35
1984		1.59	1.22	.55	.57	.37
1985		1.71	1.31	.59	.60	.40
1986		1.73	1.32	.59	.60	.41

*: Numbers do not add due to the omission of a number of small items that are also a part of the domestic nonfinancial catagory

If the Federal Government's debt and annual borrowing requirements had grown somewhat more slowly, the supply of domestic savings would have covered a larger share of the economy's domestic borrowing requirements, and a smaller volume of foreign savings would have been required to finance the private sector's investment requirements.

Household Sector Borrowing

During the past six years, disposable personal income rose by 40 percent, outstanding home mortgage debt increased by 49 percent, and outstanding consumer installment credit increased by almost 76 percent. The annual pace of household borrowing increased from $121 billion in 1981 to $283 billion in the second quarter of 1986, or 134 percent. While disposable personal income was increased by $850 billion, total household debt was increased $905 billion.

Some analysts have suggested that the actual growth of household borrowing and outstanding consumer debt may not be as rapid as these statistics initially suggest, for two reasons -- the growing use of credit cards for "convenience" purposes and the lengthening of maturities of new consumer loans. For example, when consumers use their credit cards as a substitute for paying with cash or check and pay their outstanding balance at the end of the month, they are not really borrowing, although every charge transaction counts as consumer borrowing in the household debt statistics. Similarly, the average maturity of consumer debt has increased noticeably during the past few years -- as in the case of the average maturity of auto loans, for example, from 45 months in 1981 to 51 months today. With longer maturities, a smaller percentage of the outstanding balance is retired each month, with the result that the slower repayment pace would appear to increase the growth of consumer debt even if the rate of new borrowing does not accelerate.

Estimates prepared by Federal Reserve Board economists suggest that these two factors were relatively minor, contributing less than two percentage points to the annual increase in total household debt.

Business Sector Borrowing

According to the Federal Reserve Board, the business sector's internally generated funds increased by $67 billion between 1981 and the second quarter of 1986, with approximately 90 percent of that aggregate increase attributable to the accelerated depreciation provisions of the 1981 tax bill which greatly reduced the business sector's tax liability. The funds generated by the 1981 bill did not prove adequate to meet the business sector's demand for funds, however, and outstanding business debt increased by more than $910 billion, or 57 percent, between 1981 and the second quarter of 1986.

According to the Department of Commerce, net nonresidential fixed investment was only $19 billion higher in 1985 than in 1981, suggesting that only a small fraction of the additional borrowing and tax-law-induced depreciation allowances were used to finance net additions to the business capital stock. In general, this has given rise to concerns that business borrowing in recent years may not have been used to finance productive investment of the kind that would make U.S. businesses more competitive and raise U.S. living standards.

For this reason, Federal Reserve Chairman Volcker has observed that the heavy reliance in recent years on foreign capital "might be acceptable _if_ we were matching the foreign borrowing with a surge in productive investment in the United States. That's been the case at times in the distant past in the United States and in other countries more recently. But we are not making that match now -- it's been consumption that's been leading the economic parade" (emphasis in original).

Conclusion: "Crowding Out" in the U.S. Economy

Despite the rapid and simultaneous growth of household, business, and Federal Government domestic demand for credit without a corresponding increase in the supply of domestic savings, crowding out does not seem to have become a problem.

In 1983, 1984, and 1985, the Federal Government's demand for credit increased at annual rates of 18.8 percent, 16.9 percent, and 16.2 percent, respectively. Traditional economic theory suggests that, when Federal Government borrowing increases more rapidly than the available pool of savings, interest rates rise and start "crowding" private-sector borrowers out of the credit markets.

The private sector is generally the one that retreats in the face of higher interest rates because businesses must compare the cost of borrowing with the rate of profit they expect to earn with the borrowed funds, and households have to weigh the desirability of borrowing for a new home or car against the costs of servicing the added debt. The Federal Government, however, does not reduce its borrowing merely because interest rates have increased, and if increased Federal Government borrowing leads to higher interest rates, growing numbers of private-sector borrowers postpone their investment and borrowing projects. Because of higher interest rates, in other words, they are "crowded out" of the credit markets.

For the past three or four years, government borrowing does not appear to have displaced private-sector borrowing. On the contrary, both have increased simultaneously, and at unprecedented rates, while interest rates have generally been declining. Some analysts therefore conclude that crowding out is in remission.

This conclusion may be premature. Crowding out continues to occur, but with today's greater international capital mobility, it takes a different form and affects different economic sectors. When financial capital was less mobile, interest-sensitive sectors such as home building and business investment suffered from crowding out, slowing dramatically when interest rates rose and regaining strength in the early stages of recoveries when interest rates are generally low. As the large influx of foreign savings illustrates, the supply of credit in domestic financial markets is no longer constrained by the domestic savings pool. The inflow of foreign savings is now close to 3 percent of GNP and constitutes just over 20 percent of the total gross savings generated by the United States.

International capital mobility means that foreign savings can now be mobilized if the domestic demand for credit outstrips the domestic supply of savings. This reservoir of foreign capital, which helps moderate interest rate fluctuations, shifts but does not eliminate the traditional crowding out process. By raising the value of the dollar, the influx of foreign capital, while not affecting interest-sensitive sectors, creates pressures on those sectors exposed to foreign competition -- in particular, U.S. exporters and domestic industries that must compete with foreign imports.

The crowding out process would once again shift back to the interest-sensitive sectors if for any reason foreign capital outflows are halted, the dollar falls, and U.S. interest rates rise. In a world of international capital mobility and floating exchange rates, trade-sensitive sectors can also feel the pain of crowding out when the domestic savings pool cannot accommodate the domestic demand for credit.

b. Economic Implications of Merger and Acquisition Trends

The current wave of corporate takeovers and other mergers and acquisitions is heralded by some as a restructuring and revitalization of U.S. industry, and by others as a speculative mania with alarming parallels to the corporate pyramiding that led up to the 1929 stock market crash. The trend is distinguished by two significant features: first, the growing number of hostile takeovers, and second, the fact that they are often accomplished by financial experts with little expertise or experience in the business of the firms they acquire. The controversy has been intensified by the recent revelations of widespread violations of the laws prohibiting insider trading, implicating leading figures involved in some of the takeovers.3/

Magnitude of Trends

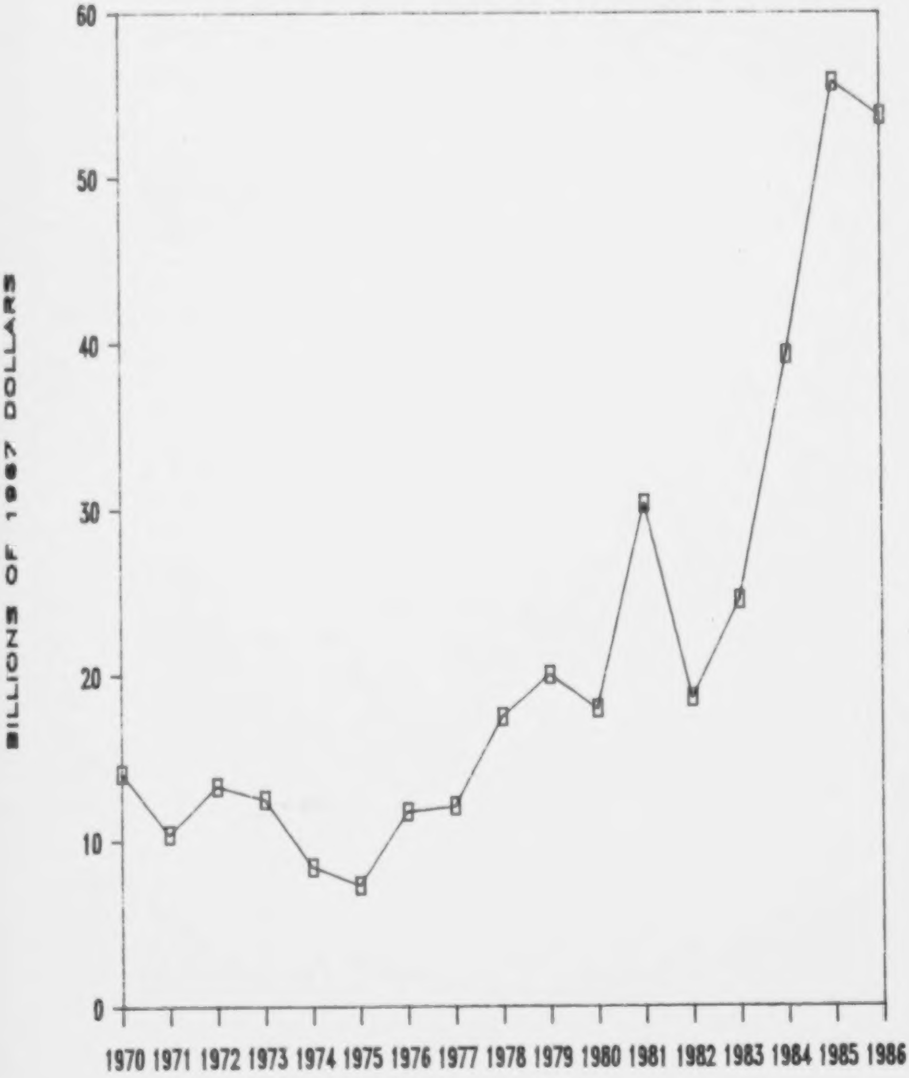
The magnitude of the activities suggests the degree to which they are capable of influencing profoundly the structure and performance of the industrial sector and possibly the economy as a whole. According to figures compiled by W.T. Grimm & Co., a private research firm, the total value of merger and acquisition activities was $176.6 billion in 1986, about four times the 1980 amount. The Federal Trade Commission (FTC) formerly collected and published information about these activities but discontinued the practice in 1982.

Mergers and acquisitions were more numerous during the peak period of conglomerate mergers in the late 1960's and early 1970's, but those of the past several years have increasingly involved larger firms with greater assets. There was an annual average of about 4,900 mergers and acquisitions in the 1968-1973 period, with an average value for those reporting a purchase price in constant 1982 dollars of about $30 million. The number of mergers and acquisitions averaged about 2,700 per year in the 1981-1986 period, with an average reported value for each of about $86 million, in constant dollars. Last year alone, there were 26 takeovers of $1 billion or more.

3/ The Committee's concern is with the economic consequences of these actions: whether they improve or impair efficiency and the productive use of capital; and whether, and on what basis, assessments can be made.

CHART XLV

TOTAL VALUE OF MERGERS AND ACQUISITIONS



Arguments in Support of Takeovers

The proponents take the position that mergers and acquisitions, even when hostile, are beneficial because they promote redeployment of assets to higher valued uses, economies of scale, more efficient forms of distribution and contracting, technology transfer, and improved management. Responding to complaints that those engaged in takeover attempts use unfair and sometimes illegal tactics, the Council of Economic Advisers stated in its 1985 report that the evidence "suggests that abusive practices in the market for corporate control are limited largely to tactics employed by target managements who, in opposing takeover bids, defeat or deter tender offers at the expense of their shareholders and the economy."

The Administration's implicit criticism of corporate management has been stated in more forceful terms by Deputy Secretary of the Treasury Richard G. Darman. In a recent series of speeches, Secretary Darman criticized management officials for being part of a "corpocracy" which is "bloated, risk-averse, inefficient, and unimaginative." He has praised takeover bidders as a new kind of populist folk hero, taking on not only big corporations but the phenomenon of corpocracy itself.

An alternative view, somewhat kinder to target executives, is that, while takeovers result in more efficient use of assets, they are not all caused by inefficient target managements; inefficiency may be only one of several causes. Economists working at the Securities and Exchange Commission (SEC), and others, emphasize the "synergies" that can be realized from asset combination. In this view, entrenched and inefficient management is only one of many possible reasons that outsiders perceive gains from a takeover.

Proponents argue further that shareholders benefit because takeovers, and the fear of takeovers, increase stock prices and make management more attentive. They point to studies showing that stock increases in value when tender announcements are made and that shareholders profit in successful takeovers, and they reject arguments that takeovers are primarily the work of speculators seeking control of a company in order to sell off valuable assets for quick gains, although they recognize isolated cases of that kind.

Criticism of Takeovers

Critics maintain that unfriendly takeovers, especially those accomplished through leveraged buy outs, do more harm than good, especially as corporate takeovers as well as defensive stock redemptions financed by junk bonds have added substantially to corporate debt and increased debt-to-equity ratios to dangerous proportions.

The critics view those engaged in unfriendly takeovers as "raiders" who tend to take advantage of the fact that stock prices of firms with large long-term investments are often lower than the stock of firms that avoid long-term investments in order to pay higher dividends. In effect, companies committed to long-term planning in the interests of preserving and expanding market share are more vulnerable to takeover bids. Studies by Frederick M. Scherer, David Ravenscraft, Edward S. Herman, Louis Lowenstein, and the Investor Responsibility Research Center indicate that profitability of companies after a hostile takeover is no greater than before and that target firms had healthy average pre-offer returns on stockholder equity. These studies suggest that the new managers are no more efficient than their predecessors.

Critics also point to the fact that the success of these maneuvers has in a number of cases encouraged management of targeted firms to resort to defensive tactics, causing a shift in the focus of corporate activities from long-term growth and development to short-term paper profits -- e.g., selling off divisions and distributing the proceeds to the shareholders, and closing down plants and laying off managers and workers. Another common defensive tactic involves buying back the high-priced shares accumulated by the prospective new management, leaving targeted companies with sizable debts which impose significant repayment obligations and constitute an obstacle to investment in R&D and other projects vital to the long-term health of the firm, especially in a period of slow economic growth and increased market competition.

The broader ramifications of merger/acquisition trends, which have accelerated markedly since 1980, remain very difficult to assess. While there is a consensus on the need for U.S. industry to use capital resources more efficiently, there is no agreement over whether takeovers do serve this objective. Proponents maintain that there is, in effect, an unplanned restructuring of industry that will make the United States more efficient and competitive, while critics assert that takeover activities create a bias against long-term planning that will make industry less competitive, and that the increased indebtedness threatens financial stability. There is disagreement as well over whether these trends have led to greater concentration in industry.

The Need for Information

Many of the economic questions surrounding the merger/acquisition controversy cannot be resolved in the absence of more complete information. Unfortunately, no serious effort by the Administration is underway to collect and analyze relevant data in a timely fashion. With respect to concentration, the data are not current. The most recent statistics on concentration ratios in manufacturing, published by the Census Bureau, date from the 1982 census, when the current wave of merger/acquisition activity was just getting underway. The results of the census scheduled for 1987 will not be published for another two or three years.

In other areas, the Administration has actually taken steps to reduce the number and quality of statistical series bearing on the effects of mergers and acquisitions. In 1982, the FTC ceased collection and publication of information which had been routinely collected since 1948 about the number and value of merger and acquisition activities. This was done on the initiative of then-FTC Chairman James C. Miller, currently Director of OMB, on the grounds that virtually identical data are published in the private sector, although at the time Mr. Miller acknowledged in congressional testimony that some information gathered by the FTC under the Antitrust Act was not in the public domain, and that "the FTC has published more variations of merger statistics than private reporters."

The Federal Trade Commission also took actions concerning two other statistical series in 1982. It transferred the Quarterly Financial Report Program, which until then contained some concentration data, to the Census Bureau. It also suspended collection of the Line of Business data despite the fact that the agency was aware that the data could be useful in evaluating the effects of mergers and in identifying types of industries to which enforcement efforts might be targeted.

There is a broad consensus about the need for U.S. industry to improve the efficiency of its use of capital resources and restructuring could be a step in that direction. The question is whether the kind of restructuring imposed upon industry by hostile takeovers contributes productively to the industrial base and the economy. Fuller information about the trends in concentration, company-financed R&D spending, and long-term finance is needed to assess the long-term economic ramifications of current merger/acquisition activities as well as the overall effects on industrial performance. At the same time, however, there is sufficient information to be concerned about two readily identifiable aspects of merger and acquisition trends.

Current Issues

Insider Trading Abuses

There is already substantial evidence of violations of the insider trading laws, with many of the violations involving mergers and acquisitions. Disclosures of abusive practices are likely to increase in the coming months as SEC, law enforcement, and congressional investigations move forward.

From an economic perspective, these illegalities and excesses pose a threat to the integrity of the securities markets. The importance of these markets to the free flow and allocation of private capital cannot be overestimated. The economy depends greatly on the continued operations of these markets, and if public confidence is to be maintained, it is critical that the markets function in a fair and open manner, in accordance with the law.

A major premise of the securities laws is that all shareholders are entitled to equal treatment with respect to opportunities to make informed investment decisions. Insider trading abuses undermine the foundation on which this premise is built. Over the long term, if abuses are not curbed, public confidence in the securities markets will be eroded to the detriment of the overall economy.

Corporate Debt

There is also substantial information on the effects of mergers and acquisitions on corporate indebtedness. The surge of borrowing that has accompanied merger activities raises serious questions about the extent to which financial resources are being used for acquiring and reselling existing assets rather than for investment in new capital plant or research. Some of the debt incurred in connection with large takeovers takes the form of junk bonds -- high-yield, low-rated instruments usually obtained because investment-grade credit ratings are not available. This type of debt often carries with it interest rates in excess of the return on investment of the target firms which, when payable, may require divestment of holdings, cutbacks in R&D and capital spending, and reductions in employment. The fact that such decisions are being driven by takeover actions causes many people to conclude that the need for new investment is being neglected.

Second, the enormous volume of debt causes concern about the financial viability of large segments of the corporate sector. During the past several years, corporations have been using their financial resources to reduce equity rather than to create new equity. There were net retirements of equity amounting to more than $80 billion in each of the past two years (see estimates in Table VIII). The rise of this form of indebtedness is indicated by the figures for new equity issues and equity retirements (which include equity retired through mergers, leveraged buy outs, share repurchases, and other restructuring plans). In 1983, new issues exceeded retirements by $28 billion. In 1984, retirements exceeded new issues by $77 billion; in 1985 and 1986, retirements exceeded new issues by $81.5 billion and $80.8 billion, respectively.

TABLE VIII

OFFERINGS AND RETIREMENTS OF EQUITY BY NONFINANCIAL CORPORATIONS

	New Issues Including Private Sales	Retirements*	Net Change
	- - - - billions of dollars,	annual rates - - - -	
1980	21.1	8.2	12.9
1981	21.5	33.0	-11.5
1982	28.9	17.5	11.4
1983	40.0	11.7	28.3
1984	18.0	95.0	-77.0
1985	25.0	106.5	-81.5
1986p	38.2	119.0	-80.8
1986-Q1	33.0	92.0	-59.0
Q2	41.5	120.0	-78.5
Q3	31.5	112.0	-80.5
Q4p	47.0	152.0	-105.0

* Includes equity retired through mergers, leveraged buy outs, share repurchases, and other restructuring plans.

Source: Federal Reserve

These data suggest that debt/equity ratios, which had been increasing for some time, have been rising at an even faster rate in the past few years. The increase in the high-interest debt relative to the equity of many corporations raises doubts about what might occur in the next recession. Felix G. Rohatyn, testifying to the Senate Banking Committee in January, said of takeovers and the use of junk bonds, "this activity...causes the weakest sectors to acquire large amounts of risky and possibly illiquid paper to show performance. Much of this paper has never been tested in a period of economic downturn." Rohatyn referred to this matter as a financial time bomb ticking in the closet.

In the same hearing, Nicholas F. Brady, Chairman of Dillon Reed, referring to the "unsoundness" of junk bond takeover financing, said: "conditions in 1987 are reminiscent of those prevailing in 1968, just before the last big downturn: a boiling stock market, high profits on Wall Street, and a takeover binge fueled by the activities of 'go-go mutual funds.'"

c. Infrastructure

The efficient functioning of private markets and the national economy depends significantly upon the physical infrastructure -- the highways, railroads, bridges, mass transit systems, and ports that keep products and people moving, as well as the water and sewer systems essential to service growing populations. The importance of a particular facility to a local community, state, or region is usually self-evident, and every region of the country can cite part of its own infrastructure whose economic importance reaches far beyond the region's own borders.

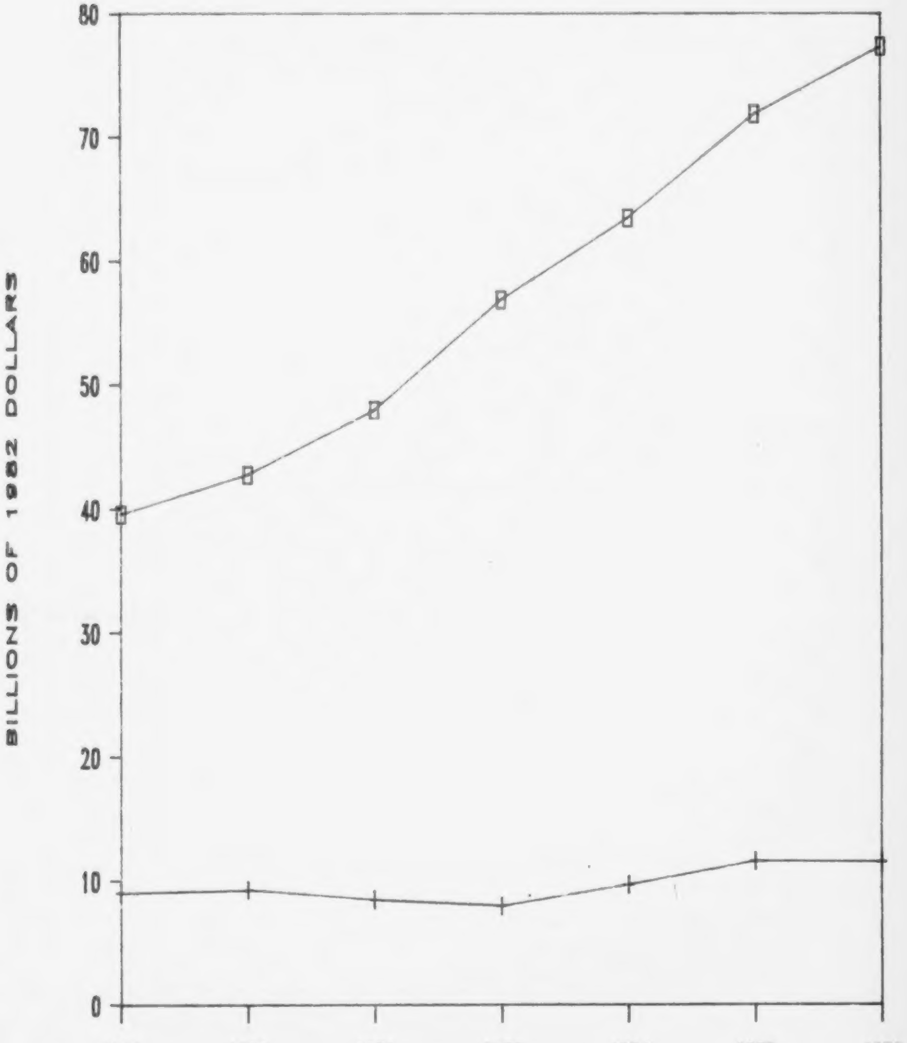
Much of the Nation's basic capital support system is aging. Some of the most heavily used sections of the interstate highway system are almost 30 years old. Mass transit systems in older cities date from the turn of the century or before. The water systems in most large cities are more than 100 years old. Since the mid-1960's, there has been a general failure to repair and maintain these facilities.

In 1984, this Committee issued a landmark study on infrastructure, Hard Choices, A Report on the Increasing Gap Between America's Infrastructure Needs and Our Ability To Pay for Them. The report, a major effort to define the magnitude of the infrastructure problem as seen by the states themselves, concluded that a national gap exists between anticipated revenues and basic infrastructure needs approaching $450 billion through the year 2000. Planned spending would have to increase substantially to meet the perceived needs.

The necessary level of effort remains a subject for discussion, and there are studies whose estimates are both higher and lower than that of the Committee's report. The question of the relative roles of the Federal and state governments also remains undecided. Nonetheless, there is broad agreement on the need for improved and expanded infrastructure. If investment in this form of physical capital is not increased, economic growth

CHART XLVI

MAJOR PHYSICAL CAPITAL INVESTMENT



□ DEFENSE + NON-DEFENSE

and development will suffer. The complex set of issues outlined in the Committee Report has been analyzed in some detail by the American Planning Association (APA).

The APA distinguishes three types of infrastructure decline, each with different implications for local economic development. At one extreme is sudden system failure, such as a bridge collapse or a water-main break. A second problem is general facility deterioration, or a gradual "chipping away" of the capital plant. Although general deterioration may increase the probability of sudden failure, the two categories are clearly distinguishable; some of the sudden failures are caused by design flaws or external hazards rather than the cumulative effects of aging. The last type of infrastructure inadequacy identified by the APA is capacity constraints, which limit the old infrastructure network's capacity to handle the volume or specialized nature of the demands now being placed on it.

An example of system failure is the collapse of the Mianus River Bridge in Greenwich, Connecticut, in June 1983, just nine months after the bridge was found "not to be in need of major repair" by the state's transportation department.4/ Aside from the direct costs of repairing the bridge, estimated in the range of $30 million, the indirect costs were borne largely by local merchants and residents; trucking and related industries; and the communities and states as a whole.

More common and more preventable than total system failure is continuing infrastructure decline. In southwestern Pennsylvania, for example, many bridges have been closed or posted with weight restrictions because of the high repair costs and the growing backlog of needs. The resulting detours have led to direct costs, including additional vehicle costs, additional driver time, and additional road maintenance costs -- and indirect costs -- additional costs of providing public services and costs incurred as a result of lost business. According to the Pennsylvania Economy League, for the 33 bridges closed and restricted in the six-county region, measurable costs amounted to about $38.5 million per year. If all of the 540 posted bridges are included, the cost is estimated at $188 million annually.

4/ The report of the National Highway Transportation Safety Board found that maintenance neglect was a contributing factor, although a special engineering study commissioned by the State of Connecticut concluded that the bridge failed because of inadequate structural support that would have led to failure regardless of maintenance practice.

The third form of infrastructure inadequacy is capacity constraints. In Houston, a mismatch between slow highway expansion and large increases in vehicle miles traveled has led to steadily worsening traffic congestion and travel delays of 35-45 minutes during rush hour -- a common situation in communities around the Nation.

A report prepared by The Road Information Program (TRIP) on employment effects of Federal highway expenditures concludes that, for each $1 billion loss in Federal highway spending, 41,600 jobs would be lost in a wide range of industries, including: highway and related construction; service industries (business, health, personal services, new auto dealers, education, auto repair, hotels, and others); and transportation.

Despite fundamental importance and the complexity of the national infrastructure, Federal funding in recent years has been erratic. Federal spending for nondefense infrastructure rose steadily throughout the 1970's, reaching a peak of $35 billion (in FY 1982 dollars) or 5.5 percent of Federal outlays by FY 1979, but then dropped sharply, reaching bottom in FY 1983 when real spending totaled $28 billion or 3.5 percent of Federal outlays. Between 1983 and 1986, Federal spending on infrastructure recovered to its FY 1979 level. Despite the continuing need for maintenance and improvement and the evident importance to the economy of dependable transportation and water facilities, the Administration has recommended that Federal spending for infrastructure be reduced during the next two fiscal years.

It is all too easy to overlook the problems associated with infrastructure deterioration, since in a world of limited resources projects which tend to emphasize maintenance and improvement are often assigned lower priority than they deserve. The price of this neglect is considerable, holding out the prospect of significant dislocation that the economy can ill afford.

CONCLUSIONS

1. Growth in productivity is the key to future prosperity. Improving productivity performance will require steady and sustained efforts across a broad front -- initiatives to increase capital formation, to build a vigorous, educated, and skilled work force, to assure higher levels of civilian R&D, and to maintain a strong and dependable physical infrastructure.

2. The policies of the recent past have led to a severe imbalance between savings and investment in the U.S. economy. This balance must be restored, but to do so by cutting back sharply on investments in plant and equipment would pose a threat to future growth. Savings must therefore be increased through a variety of mechanisms, including faster income growth which stimulates household savings, and a reduction in the dissaving associated with the Federal budget deficit.

3. The economic consequences of the recent trends in mergers and acquisitions have not yet been fully analyzed, in part because the data needed for thorough evaluation are not available. Government agencies, particularly the FTC and the SEC, should move swiftly to compile and publish regularly comprehensive information needed to evaluate the scope, extent, and effects of takeover activity. While merger/takeover activities are complex, a prompt and concerted effort must be made to identify and prohibit abusive practices.

4. In a number of areas, abusive practices clearly threaten the integrity of capital markets. Public authorities therefore should act promptly to enforce existing laws and enact new ones where necessary to provide full disclosure of information and guarantees of sound financing for proposed takeovers. These steps are justified by the present state of knowledge concerning abusive practices in financial markets, and as new information is accumulated there may be justification for additional steps to improve the functioning of our domestic capital market.

5. Attention to the state of the infrastructure on which the functioning of the economy depends must be an essential role of government if the country is to achieve its maximum long-term growth potential. That role unfortunately has been neglected over the recent past, and all levels of government should reverse the policies of neglect which have prevailed over the past several years.

3. U.S. HUMAN RESOURCES

a. Employment/Unemployment

The Employment Act of 1946 recognizes the responsibility of the Federal Government to use "all practicable means" to promote full employment, and further requires efforts to reduce the differences in unemployment rates among youth, women, minorities, and other labor force groups. Little attention has been paid to these goals in this year's Economic Report of the President. The CEA points out in its report that participation of women in the labor force has increased (without however addressing the question of the extent to which the large-scale entry of women into the labor force is related to declining family income), and that the unemployment rates for men and women are now roughly the same. Otherwise, the report pays no sustained attention to the problem of unemployment and the closely related problem of poverty, and indeed forecasts only a modest decline in unemployment in 1987.

While the civilian unemployment rate for 1986 was slightly below the 1980 rate -- 7.0 percent as opposed to 7.1 percent -- the number of persons unemployed actually rose during the same period, from 7.6 million to 8.2 million. The rate of job growth in the 1980-1986 period was significantly below the growth rate of the late 1970's.

Nonetheless, the U.S. economy did generate 10 million new jobs over the past six years. Continuing the trend of strong job growth for women established in the 1970's, two-thirds of these jobs went to women, whose labor force participation rate rose as unemployment among women also declined. Employment for men also rose between 1980 and 1986, but at a much slower rate than for women, and the unemployment rate for men, 6.9 percent, was the same as the 1980 rate. Total teenage employment fell during the 1980's, consistent with the decline in the teenage population.

Whites continued to fare better than blacks. While in 1980-1986 the white employment rate declined from 6.3 percent to 6.0 percent, the black unemployment rate remained at 13.1 percent. The problem is particularly acute for black teenagers, for whom the official January 1987 unemployment rate was nearly 40 percent, compared to 15 percent for white teenagers.

Overall, the Bureau of Labor Statistics estimates that the unemployment rate would be 10.2 percent if involuntary part-time employment and "discouraged workers" were taken into account. Although part-time work accommodates the needs of 14 million workers, there are 5.2 million who work part time involuntarily either because full-time jobs are not available or their hours have been reduced. In addition, there are an estimated 1.1 million unemployed workers who have given up looking for jobs because they are not available.

These trends should be seen against the background of more stringent conditions for the unemployed and reduced opportunities for the employed.

Being unemployed today is a more serious problem than in the past. The median duration of unemployment has fallen to 7 weeks, from 10 weeks at the bottom of the 1981-1982 recession, but of those who are unemployed, 2.2 million have been jobless for 15 weeks or more, a very high rate for this point in the recovery.

Unemployment insurance can no longer be counted on as a dependable source of transitional income. Of the eight million currently unemployed, only 30 percent receive any unemployment benefits, compared to 62 percent in 1975 and 50 percent as recently as 1980. The average weekly benefit of $137.00 is barely 60 percent of the poverty level for a family of four. Job training is also less widely available as an alternative to unemployment. Federal outlays for training and employment services have been cut in half since 1980, from $10.3 billion to $5.2 billion in 1986. The President's greater emphasis on job training in his competitiveness initiative is a welcomed development.

For those who are employed, there have been major changes in the quality of jobs and wage levels. One of the most serious problems is the loss of manufacturing jobs. Manufacturing employment declined by 2.3 million in the 1981-1982 recession, but in the ensuing 50 months of expansion, only 1.1 million of those jobs have been recovered. Of the 20 manufacturing industries surveyed monthly by the BLS, eight have continued to lose employment since the bottom of the recession. Virtually all of the job growth during the past six years has been in service-producing industries, with the strongest growth occurring in retail trade, business services, and the finance, insurance, and real estate industries. While some service-producing jobs pay high wages, many pay less than the manufacturing jobs being lost. In retail trade, the most rapidly growing source of employment, average hourly wages are only 60 percent of average hourly wages in manufacturing. Given the shorter hours in retail trade, average weekly take-home pay is less than half that in manufacturing.

This shift in the structure of job growth to lower paid industries is compounded by two other problems -- a shift within each industry from higher to lower paying jobs, and an actual reduction in pay for the same work.

Since 1981, increases in the average hourly earnings index (which only includes wages for production and non-supervisory workers) have declined more rapidly than in the employment cost index (which includes a wider range of employees). Since the employment cost index is adjusted to account for changes in the industrial composition of employment and gross occupational composition, the CBO interprets the divergence in the two indices as evidence that the composition of employment has shifted toward lower paying jobs.

Many workers have had to take lower pay for the same job. During the last three years, a number of unions have agreed to wage cuts and benefit cuts in give-backs to employers. Ten percent of the workers whose contracts were negotiated during 1986 took pay cuts averaging 9.3 percent, and another 20 percent received no increases; almost all the wage cuts occurred in manufacturing industries. Benefits were also reduced for many workers, including elimination of cost-of-living adjustments (COLA's) for 17 percent of workers with 1986 contracts. Two-tier wage contracts have a similar result, setting a lower pay scale for new hires than for more senior workers for the same job.

One final disturbing trend has been the recent growth of job categories -- part-time and temporary jobs -- that do not include normal job-related benefits, such as health insurance and pensions. These jobs mean reduced costs to employers, since benefit costs are low or nonexistent and workers in these categories can be added or laid off more rapidly than permanent workers as production schedules change.

b. Income and Poverty

The quality of new jobs has influenced trends in wages and income. Real family income today remains below that of 1979, and considerably below that of 1973, because of declining real wages, the shift to low-paid service jobs, higher unemployment, an increase in the number of "low earners" (i.e., workers earning less than $212 weekly), declining Federal assistance, and changing family composition. The income of families with children has fallen even more in real terms over this period, reflecting the loss of earning power of many heads of households. By 1985, 18.6 percent of married couples were below the poverty line despite the fact that the heads of those households were employed year-round. Comparable figures for 1973 and 1979 were 12.7 percent and 14.1 percent.

Overall, real wages have declined. The average 30 year-old male who earned $23,580 (in constant 1984 dollars) in 1973 earned only $17,520 a decade later. In 1979, the average gross weekly wages of non-supervisory workers was $326.68 (in constant 1986 dollars). By 1986, the figure had dropped to $304.85, a fall of 6.7 percent. The value of the minimum wage has also fallen. A head of household working full time year-round at the minimum wage could support a family of three at the poverty line in 1979. By 1986, a similarly situated family would fall 20 percent below the poverty line.

One result of these trends is growing income inequality -- the Census Bureau's Index of Income Concentration, which measures inequality, is higher than at any time since the Bureau began collecting this measure in 1947. Another is unusually high poverty rates. In 1985, the most recent year for which figures are available, the poverty rate was 14 percent. This is an improvement over 1983, when it was 15.2 percent, but is an extremely high figure for this stage of the business cycle. In 1973 the poverty rate was 11.1 percent, and in 1979, it was 11.7 percent. In 1985 the poverty rate was a full 20 percent higher than it was in 1979.

The poverty problem has become especially acute with respect to children. In 1985, the most recent year for which data are available, 20 percent of the Nation's children were living in poverty. Poverty for families with children has increased over the past two decades and especially in recent years, a trend that correlates closely with changes in the unemployment rate and the number of low earners. High levels of unemployment and part-time employment and the decline of the real minimum wage have all contributed to this trend; another factor is the decline in recent years in direct and indirect government assistance to families with children.

c. Education and Health

Education

While there is no agreement on the precise correlation between education and productivity, there is general agreement that a correlation exists. The CEA Report notes that "Government has a critical role to play in education, which equips individuals with the basic knowledge and skills to be productive workers and lays the basis for much scientific and technical advance." Other economists, notably Edward Denison, John Kendrick, and Isabel Sawhill, have sought to quantify the benefits to the economy from investments in education and training.

Other studies have analyzed the cost effectiveness of specific education programs. A major 20-year study of preschool education published in 1984 by the High/Scope Education Research Foundation concluded that every dollar spent in preschool programs saves $7 in measured benefits, including special educational benefits and welfare services. A 1986 study by the National Center for Research in Vocational Education estimated the annual welfare, unemployment, and crime-related costs of the school drop-out population of nearly one million at $6 billion.

Despite the evident national interest in education, the Administration has taken the position that Federal education programs at all levels should be reduced. Treasury Secretary Baker told the Committee at a January hearing: "I think it's a question primarily of where the money comes from. You know that our view is that this has historically been a state and local government responsibility for the most part."

While education certainly remains primarily a state and local responsibility, the Administration's downward pressure on Federal education programs -- which for the 1988 Fiscal Year would reduce funding for the Department of Education to $14 billion from the current $19 billion appropriation, or more than 25 percent -- raises serious questions, especially at a time when several major reports have documented carefully the deteriorating quality of U.S. education. "A Nation at Risk," the 1983 report of the National Commission on Excellence in Education, established by then-Secretary of Education Bell, outlined the magnitude of the problem, identifying, among other pressing issues, the following: consistent declines in student achievement over the past quarter-century; increasing dependence on remedial education at the college level; and consistently low U.S. student performance in international comparison tests. On the last point, the Commission reported that U.S. students never ranked first or second in a survey of 19 different academic tests, and in the critical comparison -- i.e., with other industrialized nations -- finished last seven times. Comparison studies undertaken by the National Center for Education Statistics in the Department of Education and the International Association for Evaluation of Educational Achievement reported similar results.

"A Nation at Risk" focused particular attention on the problem of widespread adult illiteracy, estimating that 23 million American adults today are functionally illiterate. The report also noted a Department of the Navy estimate that 25 percent of its recent recruits were unable to read at the ninth grade level -- "the minimum needed simply to understand written safety instructions." Other estimates of functional illiteracy in the United States run much higher and, on the basis of the Census Bureau's basic literacy test, the Department of Education estimates that 27-30 million Americans are wholly illiterate and that illiteracy is widely dispersed throughout the entire U.S. population. In contrast, Japan is reported to have a 99 percent literacy rate.

In setting out an agenda for better education, the Commission underscored the necessity of joining two public commitments: the first to "excellence and educational reform," and the second to "the equitable treatment of our diverse population." Taking a similar position, a 1986 study by the Carnegie Foundation on Education and the Economy, "A Nation Prepared: Teachers for the 21st Century," concluded that failure "to provide to the many the same quality of education presently reserved for the fortunate few" will mean "a steady erosion in the American standard of living." In other words, the U.S. system of education cannot afford to sacrifice either excellence or opportunity, but must offer both.

The same criteria are applicable to post-secondary education, where the growing trend toward student indebtedness, carefully documented in a 1986 study prepared for the Committee, raises troubling questions about future access to higher education. The study, "Student Loans: Are They Overburdening a Generation?," found that, although Federal student assistance programs were originally designed to offer a flexible and balanced program of grants, work-study opportunities, and loans, the stringent reductions in the first two programs have transformed the loan program into "a major source of funds for low-income students attempting to pay for college." The study documented wider spread borrowing to finance education, significant growth in annual and cumulative borrowing, and heavier borrowing by students with relatively uncertain income prospects, and raised a series of important questions:

- At what point are prospective students deterred by debt obligations from going on to higher education, and is the deterrent effect more pronounced among minorities, women, and students from low-income families?
- How does the prospect of indebtedness affect a student's choice of college or field of study?
- To what extent will a graduate's choice of job or career be limited by debt obligations, and will capable students be deterred from taking relatively lower paying jobs in teaching at a time when the need for qualified math and science teachers is acute and an overall shortage of teachers is projected for the 1990's?
- Will a student's debt repayment obligations, over time, stand in the way of family, home-buying, or other major financial obligations?

Responding to the troubling trend in student indebtedness, the Administration has proposed radical changes in the loan program that would make repayment income-contingent, tying interest rates to market rates and extending the repayment period indefinitely while setting at 15 percent the maximum portion of annual income allocable to loan servicing. The income-contingent loan plan makes questions already raised about student indebtedness even more urgent, since the plan would have the effect of asking prospective students, at an early point in their careers, to speculate against future income. Its potential deterrent effects as well as its implications for long-term financial obligations demand very thorough examination and analysis.

Training and retraining programs independent of traditional education programs have an important role to fill, especially in a period of rapid change in the economy. In this area, the Administration, reversing policy, has proposed for the first time to expand significantly programs under the Job Training Partnership Act (JTPA). The new proposal would amend the JTPA to replace the existing summer youth employment program with a broader program offering remedial education, basic skills training, and related support to economically disadvantaged young people most likely to be unemployed, illiterate, and dependent on Aid to Families with Dependent Children (AFDC). A separate part of the proposal would address the problem of worker dislocation by also combining and expanding current fragmented retraining programs, providing education, training, counseling, and relocation services more efficiently than at present, and extending eligibility to all dislocated workers regardless of the cause of dislocation.

The new proposal represents a constructive initiative that deserves careful consideration, especially since existing JTPA employment and training programs have been estimated to reach fewer than 5 percent of those eligible. There is an apparent contradiction, however, between a policy which seeks simultaneously to reduce Federal support for education and increase Federal support for training. One Member of the Committee told Secretary Baker at the Committee's January 30 hearing that he found it difficult to reconcile "your [i.e., the Administration's] concern that we give more attention to human capital development with the proposals of the Administration in the budget to eliminate Federal funding for vocational education and to substantially cut funding for math and science education." As he pointed out, "it does not make a lot of sense to put more money into dealing with unemployment and take money out of the basic education of people who are going into the work force at a later time."

Health

Proposals for a catastrophic health program for the elderly will almost certainly be debated in Congress this year. Measures are overdue to relieve the financial burden which major illness can impose on the elderly, but the timely focus on catastrophic health issues should not obscure other important health issues, including those which have demonstrated cost effectiveness and bear directly on the future productivity of the labor force. Chief among these are children's health care and nutrition programs.

Childhood immunization has been among the most successful and cost effective of all government-assisted health programs. Dr. Frank Oski, Chief of Pediatrics, Johns Hopkins School of Medicine, testified before the Committee last year that, for every dollar spent on the childhood immunization program, the government has saved $10 in subsequent medical costs. The threat from a range of once-common and often life-threatening children's contagious diseases -- diphtheria, whooping cough, polio, measles, mumps, and rubella, the latter strongly associated with birth defects -- has been greatly reduced. Vaccination has eliminated small pox. A vaccine for bacterial meningitis has been recently introduced and several others are under development.

The immunization programs of the postwar period continued a long history of Federal commitment to control contagious diseases, in the first instance to prevent their spread between states and from foreign countries. Legislation for the licensing and regulation of vaccines and their manufacture dates to 1902.

In the 1950's, the Federal Government financed the development of a polio vaccine and, in the 1960's, provided funds for immunization against polio and other diseases. By the mid-1970's, approximately 60 percent of all schoolchildren were adequately immunized. The concerted effort undertaken in 1977-1979 by the Federal Government in cooperation with state and local governments succeeded, according to Dr. Oski, in adequate immunization "for all school-age children." Since then, however, immunization rates have declined as costs have risen, and the number of doses has declined significantly -- by roughly 28 percent for diphtheria and whooping cough, 13 percent for oral polio vaccine, and 28 percent for measles vaccine. A major step forward in child health has been stalemated by rising costs, since a program enacted last year to address this problem has not as yet been funded.

Prenatal and child nutrition programs have also proved cost effective. The WIC program is a case in point. Numerous studies have confirmed its effectiveness.5/ A 1985 study by the Select Committee on Children, Youth, and Families on "Cost-Effective Programs for Children" concluded that $1 spent in the WIC program saved $3 in short-term hospital costs, and a $1 investment can save $3.38 in the care for low birth weight infants.

5/ Among the most recent studies are: Institute of Medicine. "Preventing Low Birthweight." Washington, D.C.: National Academy Press. 1985; Schramm, W.F. "WIC Prenatal Participation and Its Relationship to Newborn Medical Costs in Missouri: A Cost/Benefit Analysis." American Journal of Public Health. Vol. 75. No. 8. August 1985; Kotelchuck, M., et al. "WIC Participation and Pregnancy Outcomes: Massachusetts Statewide Evaluation Project." American Journal of Public Health. 74:1084-1092. October 1984; Kennedy, E.T., et al. "The Effect of WIC Supplemental Feeding on Birthweight: A Case-Control Analysis." American Journal of Clinical Nutrition. 40:579-585. 1984; and U.S. General Accounting Office. "WIC Evaluations Provide Some Favorable but No Conclusive Evidence on the Effects Expected for the Special Supplemental Program for Women, Infants, and Children." GAO No. PEMD-84-4. Washington, D.C. January 1984.

Congress has repeatedly rejected Administration proposals to reduce the WIC program and has in fact provided for modest growth, but other nutrition programs have been cut back severely since 1981. Among these are the food stamp, school lunch, school breakfast, child care food, and summer food programs.

The Children's Defense Fund has testified to the Committee that reductions in the food stamp program have cut off several hundred thousand former food-stamp recipients and reduced the purchasing power of the benefits for about 18 million additional recipients. The bulk of the reductions has affected households below the poverty line.

Child-specific programs have been reduced more than 25 percent, in real terms, since 1980. Again according to the Children's Defense Fund, the number of low-income children receiving free or reduced-price lunches, and the number participating in the school breakfast program, has declined very substantially, while cuts in the child care food program, which provides assistance for children in day care, have totaled nearly $130 million yearly, forcing some day-care centers to close and others to raise fees to low-income (working) parents. The number of children participating in the summer food program, which continues the school lunch program in some low-income areas, has been reduced by about 400,000.

Short-term savings in programs to improve child health do not appear to have been weighed adequately against the longer term costs not only for medical care but in lost potential. Beyond a certain point, the loss to health and development in the early years cannot be made up at some later date. Dr. Oski told the Committee that 80 percent of brain development has occurred by the time a child reaches the age of two. While it is possible to design compensatory programs to deal with certain kinds of problems not dealt with in a timely manner, it is not now possible to design compensatory programs to deal effectively with inadequate nutrition and health care in early childhood.

CONCLUSIONS

1. The American economy at present is operating far below its capacity. There is substantial excess factory capacity, and far too many willing workers are either unemployed or underemployed. In these circumstances, clearly there is room for significant expansion in both employment and production without encountering the serious labor bottlenecks that could give rise to inflation. The economy can move toward much fuller employment without fear of inflation, and a significant reduction in the unemployment rate should be a major goal of economic policy in the year ahead.

2. One consequence of a dynamic and changing economy is an increased level of worker displacement. Coordinated policies should be developed and implemented to cushion the blow of displacement on individual workers and facilitate their rapid reintegration into the work force. The Administration's displaced worker initiative is a welcome, if belated, recognition of this reality, but more can be done, particularly in the areas of retraining and relocation assistance.

3. Government labor market information services can and should be improved. The Employment Service is in need of expansion and modernization, and new mechanisms must be found to increase the flow of information about job openings and skill requirements.

4. As change and international competition contribute to reshaping the economy, the U.S. system of education is being called upon to prepare students to meet new challenges. Particularly in light of these circumstances, Federal education programs have an essential role to play in improving education at all levels. They should be strengthened, not weakened.

5. As the government focuses on major health problems, whether protection against catastrophic illness or the challenge of debilitating disease, less dramatic but no less important programs must not be overlooked. Preventive health care programs, including childhood vaccination and maternal, infant, and child nutrition, have proven to be prudent, cost-effective investments in the future health of the population, and require continued strong support from the government.

D. SECTORAL CRISES

1. AGRICULTURE

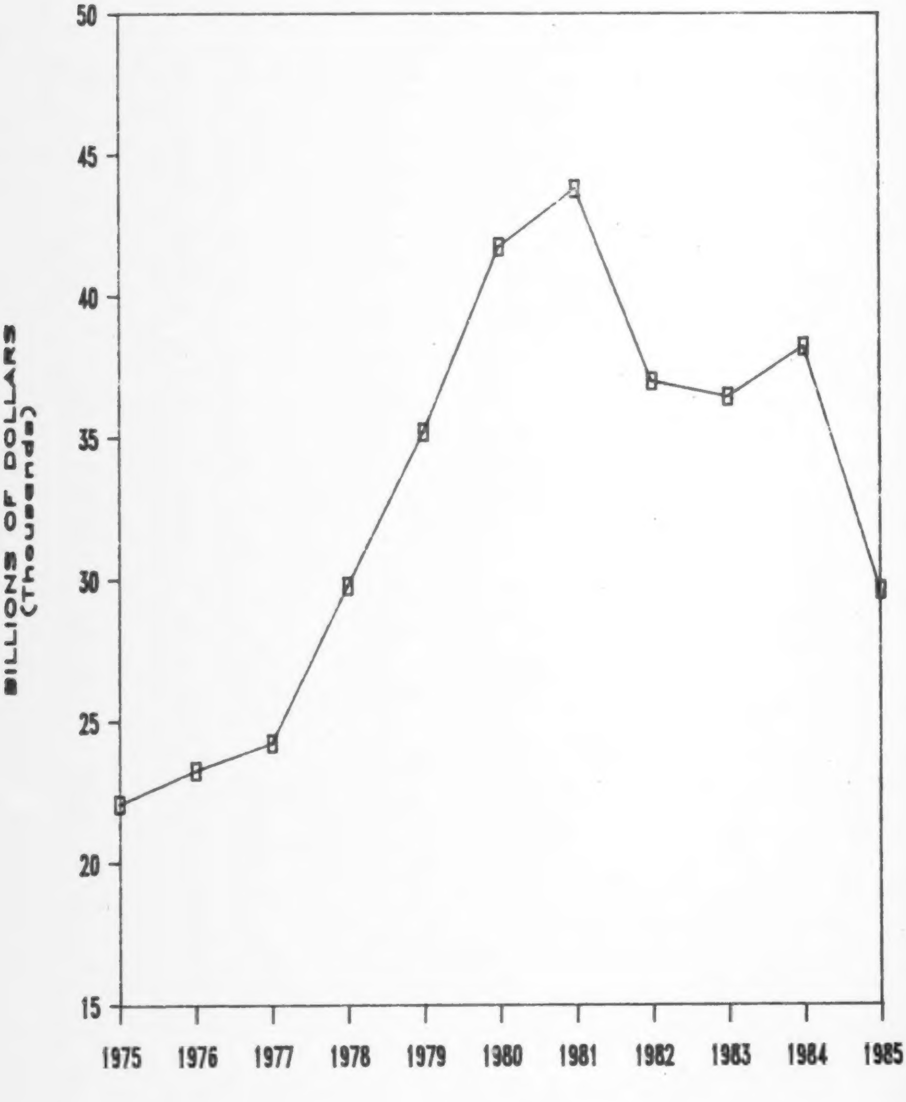
There are approximately 5.7 million Americans living on farms today. Those farm residents, who represent less than 3 percent of the population, produce enough food and feed not only to meet the needs of the remaining 97 percent of Americans, but millions of other people around the world as well. In 1933, when the first Federal farm programs were passed, about 26 percent of the U.S. population lived on farms; during that decade, the United States exported only slightly more than it imported. By 1981, despite the dwindling number of farmers -- in both absolute and relative terms -- U.S. agriculture had a trade surplus of $27 billion. The increase in production despite the declining number of farmers reflects an unparalleled productivity growth rate over the 50-year period during which, as the CEA Report notes, "public policy has played a major and, in some instances, dominant role in U.S. agriculture." The success of U.S. agriculture has enabled Americans to keep food expenses on average below 15 percent of disposable income, by far one of the lowest such levels in the world.

Since 1981, agricultural policy has been directed, as then-Secretary of Agriculture Block testified to the House Agriculture Committee, to reducing "the role of Government in agriculture both in the marketplace and in the regulatory process."

Despite this -- or because of it -- American agriculture is in the throes of what the CEA Report acknowledges to be "its most severe economic crisis since the 1930's." At the same time, commodity support programs, whose annual average costs throughout the 1970's were approximately $3 billion -- costs which were projected by the Administration to decline to less than $2 billion yearly under the FY 1982 budget proposal -- soared to $25.8 billion in FY 1986. These costs are a consequence, not the cause, of the current crisis in agriculture. Reducing them at this point, whatever the benefits for the budget deficit, could intensify the acute problems confronting U.S. agriculture.

CHART XLVII

U.S. AGRICULTURAL EXPORTS



These problems can be traced in part to the collapse after 1981 of the export markets that had expanded rapidly in the previous decade. Overseas farm commodity sales rose from $6.7 billion in 1970 to a peak of $43.78 billion in 1981. A variety of factors contributed to the surge in U.S. exports: the collapse of the Bretton Woods fixed exchange rate regime and the attendant devaluation of the dollar, the recycling to Third World countries of petrodollars generated by the Organization of Petroleum Exporting Countries' (OPEC's) newfound oil revenues, general global economic growth, and the sudden entry of the Soviet Union and other centrally planned economies into world markets as large purchasers of grain.

Responding to favorable market conditions, farmers bought and planted additional acreage to expand production. They were encouraged to do so not only by growth in world demand, but also by an inflationary climate in the wake of the 1973 oil embargo and subsequent price shock -- an era that brought very low, even negative, real interest rates. Farmers were also prodded to borrow by lending institutions, and were urged by the U.S. Department of Agriculture to produce "fencerow-to-fencerow." In 1981, therefore, when fiscal and monetary policy combined, in the words of the CEA, to drive "ex post real interest rates to postwar highs," U.S. farmers were saddled with extraordinary debt obligations. Today, the debt load carried by American farmers -- just under $200 billion -- exceeds that of any of the major debtor countries.

Recent agricultural policies have placed little emphasis on production policies, but at the same time stagnant or sluggish growth in the world economy -- a response to the 1979 oil price shock and the 1981-1982 recession -- has meant lowered world demand, while the overvaluation of the U.S. dollar placed U.S. agricultural products at an extreme competitive disadvantage in world markets. Whereas in 1978-1981 the volume of U.S. agricultural exports had increased by 45 percent and the value by 60 percent, since 1982 U.S. agricultural export volume and value have plummeted by 31 percent and 33 percent, respectively.

The debt crisis in the Third World has been a major contributing factor to this problem as debtor countries have restricted imports and expanded their own exports in order to meet debt service obligations. These countries were at one time the most promising markets for U.S. agricultural goods.

There have been problems with the developed nations, as well. In the absence of forceful counteractions from the Administration -- until recently, at least -- Japan and the European Community have pursued both mercantilist and protectionist trade policies. Japan has strong import barriers in place that limit market access to American beef, citrus, tobacco, and rice. Through the Common Agricultural Policy, the EC has engaged in unfair trade practices, subsidizing the export of its surplus farm production. The Administration's recent threat to impose 200 percent duties on European wine, cheese, and other products -- a threat whose implementation, averted only at the last minute, might well have touched off a major trade war -- is a measure of just how serious the problem has become.

The high value of the dollar has been a serious impediment to U.S. agricultural trade in recent years. Estimates vary over the degree to which the dollar was overvalued, but most experts generally agree it was in the 30-40 percent range vis-a-vis other major currencies. Until late in 1985, no action was taken to remedy the misalignment. Since then, the primary focus has been on bringing down the dollar with respect to the yen and the mark, since Japan and Germany run the largest current account surpluses with the United States. Those efforts have had little or no effect with respect to a number of other major trading countries, including several with important agriculture export and import sectors. The problem is compounded in cases where countries have taken steps to ensure that their currencies rise and fall in tandem with the dollar.

At the same time, the Administration has failed to make maximum use of food assistance programs. Despite severe worldwide hunger conditions in this decade, the value of food donations in 1986 (in real terms) under the Food for Peace program (P.L. 480) was 21 percent below the 1980 level. Shipments under the Section 416 food donation program have been modest and erratic. These programs not only provide urgently needed foodstuffs to needy countries, experience demonstrates that they contribute to the development of commercial markets for the United States, as developing countries strengthen their economies, raising their standard of living.

The developments and policies of the past few years have had truly catastrophic consequences for U.S. agriculture. Government direct payments in FY 1986 accounted for 46 percent of net farm income, whereas in FY 1980 direct payments constituted only 8 percent. It should be added that these payments are made disproportionately to large farming entities, some of which are even owned by foreign nationals. In 1981-1986, average farmland values declined by 29 percent and, in some states -- Nebraska, Minnesota, Iowa, and Indiana, for example -- by more than 50 percent. Over the same period, the farm sector's debt-to-asset ratio rose from 18.2 percent to 26.4 percent, the number of farms declined by 9 percent, or by 219,000, compared to a decline of 2.5 percent, or 63,500 farms, in 1976-1981. The rate of farmers exiting agriculture for both personal and economic reasons almost tripled from 1982-1986, rising from 2.2 percent to 6.2 percent. A recent survey of banks indicates that an additional 6 percent will not receive financing during 1987.

The collapse in the farm sector has also placed a variety of lending institutions at risk. In September 1986, 20 percent of the loans in the Farm Credit System portfolio had been designated nonperforming, as compared to 5 percent three years earlier. Farm lenders are owed nearly $24 billion by 77,000 operators with current debt-to-asset ratios above 70 percent, and experiencing insufficient income to meet financial obligations.

Other major competitive U.S. industries have also been undermined by virtue of their ties to the farming sector; suppliers and manufacturers of farm equipment, fertilizer, and seed are obvious examples. For states where agriculture is an important source of personal income, the decline represents a serious revenue loss and creates a heavy drain on resources.

Many people have lost sight of the fact that rural communities are based upon a complex and delicately balanced interrelationship among production farming, commercial marketing, lending activities, and services, all of which are essential to a healthy tax base. Once broken, that interrelationship is unlikely ever to be reconstituted, and the landscape of rural American will be irrevocably transformed.

2. ENERGY

a. Oil Prices and Inflation

Oil prices declined steadily between early 1981 and the end of 1985, falling from about $37.50/bbl to around $27.00. As 1986 began, oil prices plummeted, falling under $10.00/bbl briefly before recovering to about $18.00 by the end of the year. Substantial uncertainty surrounds the future outlook for oil prices in light of weak world demand and the questionable ability of OPEC to maintain production controls.

The fall in oil prices was initially welcomed in non-oil producing sectors because it brought lower fuel prices to consumers and an offset to inflation. The CEA Report underscores the primary role played by energy prices in keeping down inflation. It notes that the CPI actually declined at an annual rate of 4.3 percent during the first four months of 1986, while the index would have risen at a 2.9 percent annual rate absent the energy offset.

The CEA Report further indicates that energy price declines were a major factor in the increased consumer spending that was the "mainstay of overall economic growth;" this raises the question of how much slower the sluggish 2.5 percent rate of real growth would have been without the fall in oil prices.

While the 1986 inflation rate was helped by falling oil prices, it is not yet clear whether these effects will persist into the coming year. The immediate effects of falling oil prices were reflected in the CPI, but other products embodying oil as fuel or raw material may show the effects of falling oil prices more slowly. There may therefore be further price effects from the 1986 oil price decreases during 1987, although they may be more than offset by oil price increases in 1987.

Another imponderable is the apparently asymmetric behavior of the price indices as prices fell last year. In 1979-1981, oil prices rose from roughly $15.00/bbl, touched $37.50, and stabilized at $34.00 by late 1981 -- a $19 increase that more than doubled crude prices. At the same time, the GNP deflator rose from 78.6 in 1979 to 94.0 in 1981 -- a jump of 20 percent.

While circumstances are clearly different today than in 1979, the dramatic fall in oil prices in 1986 should have produced a somewhat greater drop in inflation than actually took place. Why there has not been such an impact -- or whether it has been deferred into 1987 and perhaps beyond -- deserves close scrutiny.

b. Oil Prices and Consumer Purchasing Power

Beyond the matter of how the fall in oil prices affects price indices, there is the "real" component of the change in relative prices within the macroeconomy. Lower oil prices have resulted in an effective increase in household purchasing power, but such increases are unlikely to recur.

In testimony submitted to the Committee in January, Dr. Donald Ratajczak, Director of the Economic Forecasting Center at Georgia State University, noted:

> Purchasing power has been transferred from agricultural and energy producers to the household sector. To the extent that some energy producers were from abroad, this was a net benefit to the household sector. In 1986, such transfers enhanced household purchasing power by $25 billion. No such transfer of purchasing power is on the horizon for 1987.

c. Oil Production and Oil Dependence

An additional area of concern is that domestic oil production is likely to be affected for a number of years by the recent declines in oil prices, even if prices stabilize this year. During the past year, oil production has declined from 9.1 mbd to 8.4 mbd, a drop of 8.5 percent. Chart XLVIII shows the drop in the drilling rate since 1980. The trend shown here does not bode well for future domestic oil production.

The oil industry has always invested heavily in new drilling, but the current oil price environment clearly does not provide incentive to support the level of activity seen in the early part of the 1980's. Demonstrably lower prices have made this investment less attractive and, as the CEA notes, "fixed investment in (the oil and gas) industry declined by more than $10 billion in the first half of 1986, accounting for more than half the decline in real business investment."

Declining investment also has been accompanied by a dramatic falloff in employment reflected in states where the oil and gas industries are a considerable factor in the state's economy.

TABLE IX

UNEMPLOYMENT RATES IN MAJOR OIL AND GAS PRODUCING STATES

State*	Unemployment Rate Nov. 1985 (Percent)	Unemployment Rate Nov. 1986 (Percent)
Alaska	9.5	11.0
Colorado	6.0	7.6
Kansas	4.8	5.4
Louisiana	11.3	13.4
Montana	7.2	8.3
New Mexico	8.6	9.2
North Dakota	5.7	6.1
Oklahoma	7.1	7.6
Texas	6.5	8.8
Wyoming	7.9	8.9

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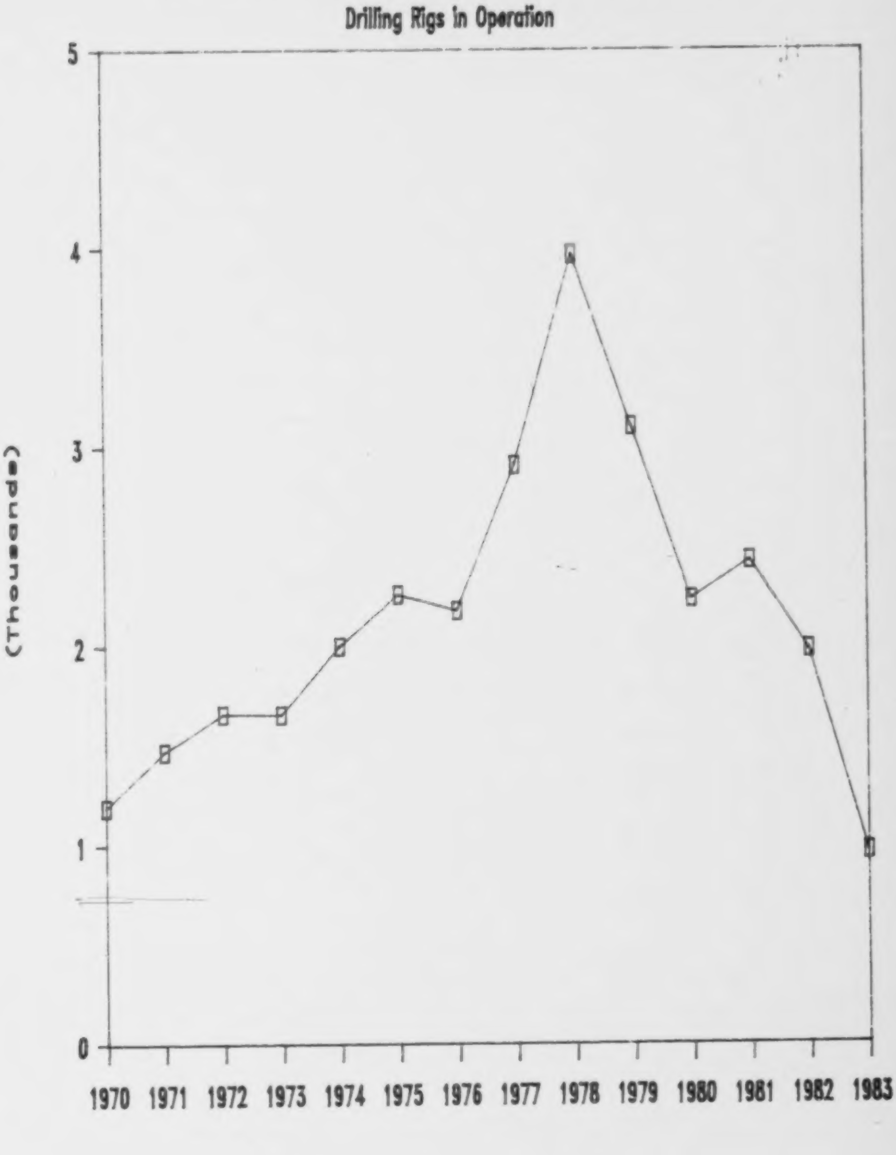
* States where in 1985 more than 2 percent of private employment was in the oil and gas extraction and refining industries.

CHART XLVIII

OIL AND GAS RESOURCE DEVELOPMENT



The table indicates that the states which depend most heavily on the energy sector for their employment have suffered severe increases in unemployment as a result of the collapse in oil prices. Unemployment levels in energy states may remain high for a prolonged period, even if drilling activity increases, both because a resumption of drilling is likely to be slow paced and because employment may increase more slowly than new drilling activity as firms attempt to maximize the productivity of existing workers.

While employment and production in the domestic energy sector are falling, lower prices inevitably have led to higher consumption, and petroleum demand is up 300,000 b/d.

Exacerbating our inability to meet our own energy demands, the Federal Government has taken several actions over the past few years that have run counter to long-standing energy independence policies. The Administration's FY 1988 budget request would reduce R&D for energy conservation by two-thirds below existing levels, would reduce purchases for the Strategic Petroleum Reserve by more than 50 percent, and would sell off the Naval Petroleum Reserves.

At the same time that petroleum demand is rising and energy conservation falling, the United States is becoming more dependent on oil imports. Imported oil accounted for 32 percent of U.S. domestic consumption in 1985 and 37 percent in 1986. Last year, in effect, all the progress made since 1981 in reducing consumption of imported oil was canceled out. Studies undertaken by the CBO, the Congressional Research Service, and the Department of Energy all foresee a steady increase in U.S. dependence on imported oil to more than 50 percent within the next five years.

Furthermore, U.S. oil imports from OPEC countries last year increased at an even faster rate than oil imports in general -- rising from 36 percent of total U.S. imports in 1985 to 46 percent in 1986. The United States appears to be reversing the movement undertaken earlier to reduce dependence on imported oil, and by the end of 1986, in fact, was relatively more dependent on imports than in 1973, when the first oil price shock occurred.

Increasing dependence on foreign suppliers with a long history of volatility is clearly not prudent long-term energy policy for the country. While the recent oil price decline has brought with it certain benefits, the long-term consequences of today's import-dependent energy policy may be more harmful to the economy than today's short-term advantages.

CHART XLIX

U.S. CONSUMPTION OF IMPORTED OIL

As Percent of Total U.S. Consumption

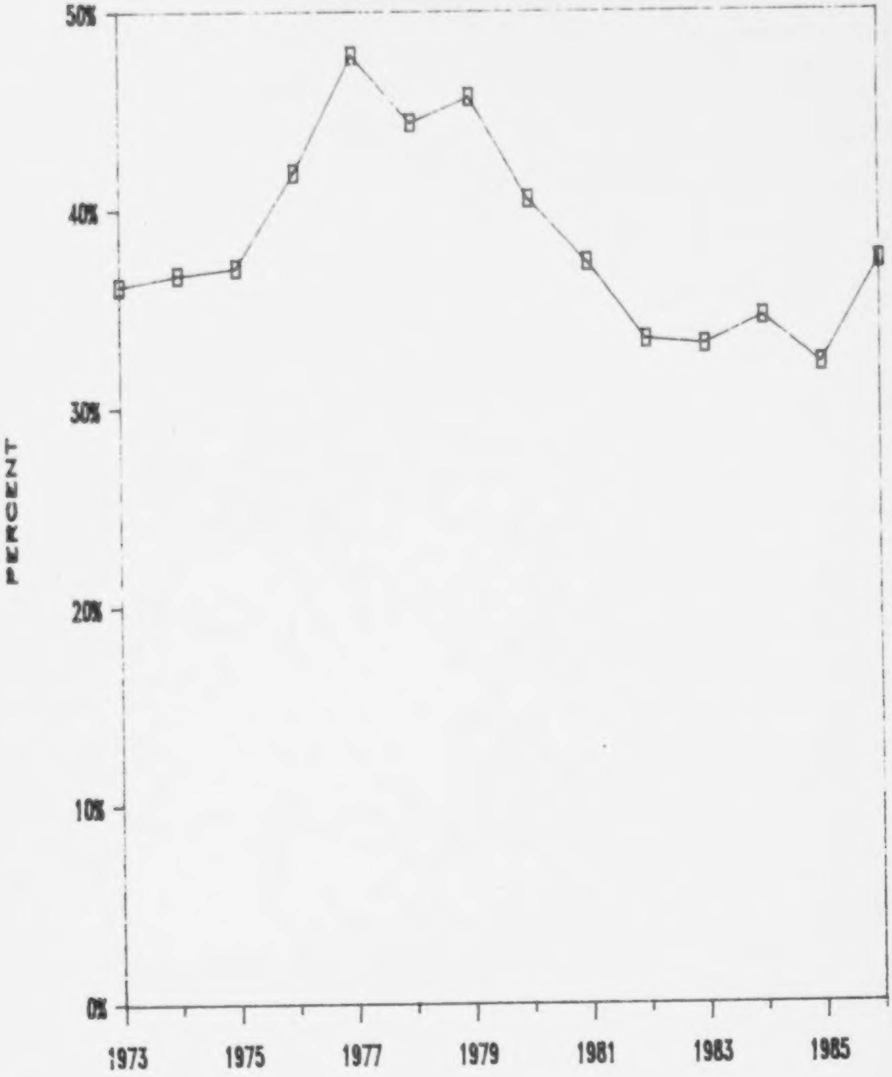


CHART L

U.S. CONSUMPTION OF OPEC OIL

As Percent of Total U.S. Consumption

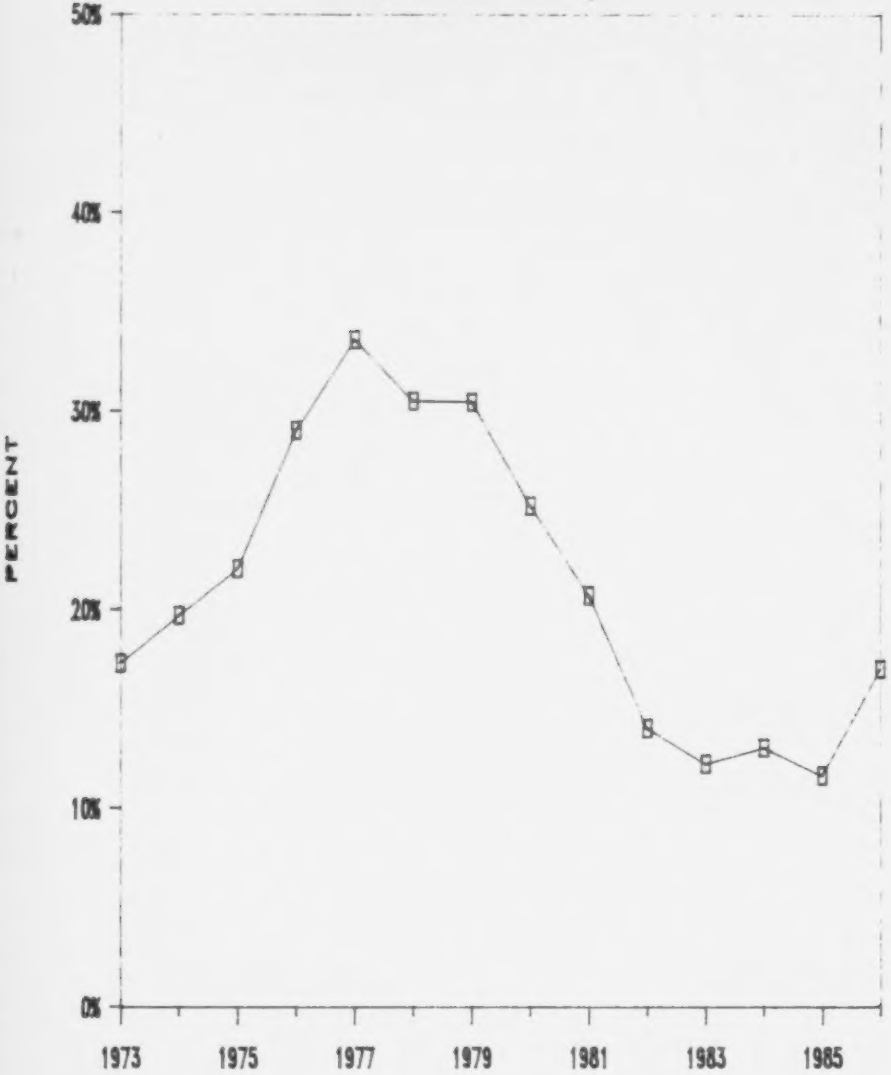
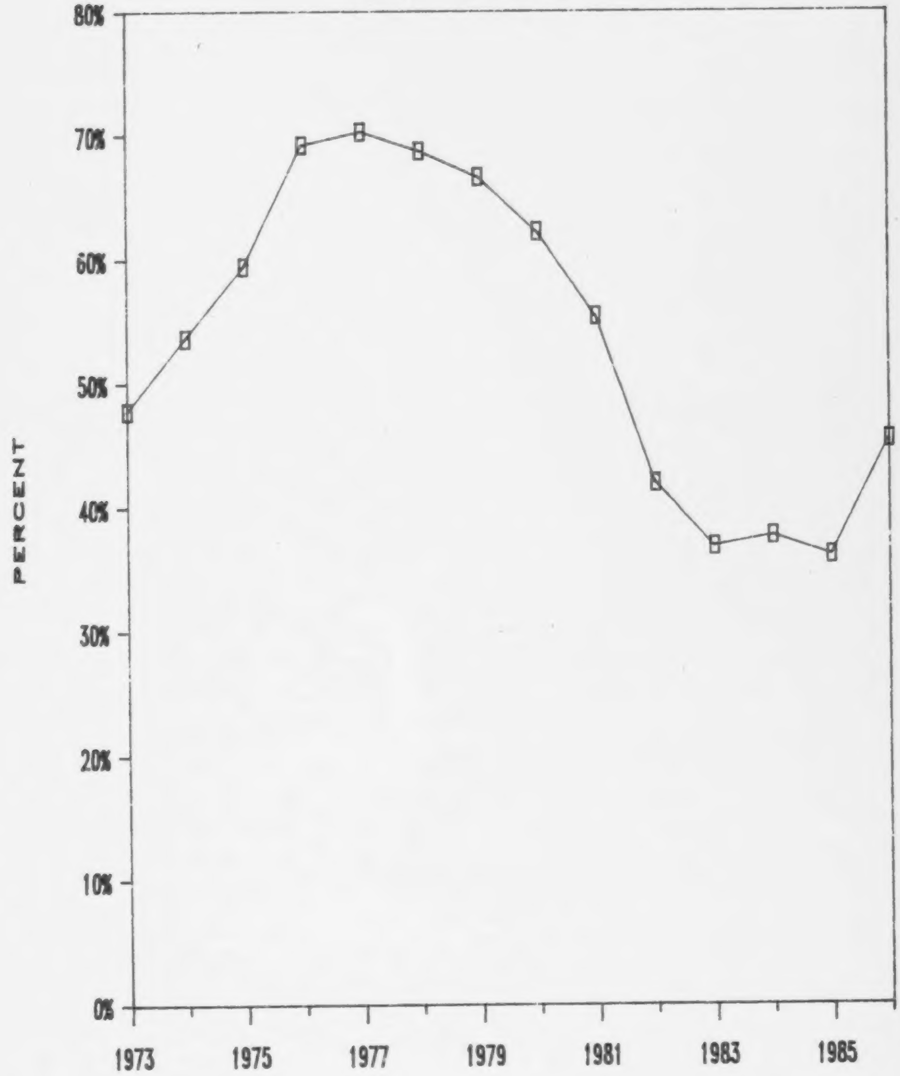


CHART LI

U.S. CONSUMPTION OF OPEC OIL

As Percent of Total Imports



CONCLUSIONS

1. Present Administration agriculture policy is an expensive failure, in large part because of its excessive reliance on export promotion as the sole solution to the farm problem. Exports are an important market for American agricultural products, but the experience of the past 15 years -- from the 1972 grain sale to the commodity glut of the early 1980's -- suggests the dangers inherent in making domestic farm policy wholly dependent on volatile external markets. The immediate challenge is to develop cost-effective agricultural policies which recognize the economic realities of the American market.

2. A significant portion of the expense inherent in existing farm policy is due to poor targeting of benefits. Improvements in targeting for Federal agriculture programs must be an essential part of attempts to reform the system.

3. U.S. dependence on foreign sources of energy has increased alarmingly over the past few years. The benefits of falling international oil prices should not blind us to our increased vulnerability to external events. Because of the past history of volatility in international energy markets, energy dependence should remain a matter of prime concern.

4. Recent policy changes have tended to minimize the importance of conservation and self-sufficiency policies. These should be reversed, and substantial new initiatives undertaken in both conservation and the development of nontraditional domestic energy supplies.

E. THE STATISTICAL BASE

There is widespread and growing concern about the adequacy of the Federal statistical base -- its ability to provide the accurate, comprehensive, and timely information on which major decisions in the private and public sectors depend, and its ability to keep pace with the rapid changes in the structure of the economy. Good statistics do not guarantee prudent decisions or sound policies, but they are an integral part of the framework of decisionmaking which make good policies and decisions more likely.

In a number of specific instances, Federal statistics have a pivotal significance for the Federal budget. The CPI, for example, serves as the base for determining adjustments in program levels that account for more than one-third of all Federal expenditures, as well as for indexing personal income tax brackets and exemptions for inflation; an error of one-tenth of one percent in the CPI estimate could add nearly half a billion dollars to the Federal deficit. State unemployment rates calculated by the BLS are the basis for determining the eligibility of states for funding under the JPTA. Local employment rates also provide the basis for payments in local areas in a variety of programs, and they are the criterion for the Labor Department's determination of labor surplus areas for the purpose of targeting some Federal contracts.

In other cases, the role of Federal statistical information may be less immediate, but it is no less significant. In hearings held in the Committee last year, witnesses identified areas where concern over statistical programs is especially acute.

1. TRADE

Although the U.S. merchandise trade balance is a key to determining the condition and assuring the future health of the U.S. economy, and can have significant effects on the foreign exchange and financial markets, monthly trade data are often unreliable. Computerized operations are only now being introduced, and data on imports, which are first obtained by the Customs Service, are still processed manually. The system has been unable to keep up with the rapid increase in import volume in recent years and backlogs have increased to such an extent that in some months more than half of the recorded imports actually entered the country in prior months. Faced with these delays, the Census Bureau, which processes and reports the trade data after receiving it from the Customs Service, no longer attempts to adjust the trade statistics for seasonal variations.

Continuing significant inaccuracies in the published figures led the Commerce Department last month to delay the monthly trade figures by several weeks and, as a result, delay the GNP report by several days, raising the question whether timeliness must be sacrificed to assure greater accuracy.

Imports now account for nearly 15 percent of real GNP, and exports account for more than 10 percent, so that inaccurate or untimely trade data can lead to misleading estimates of the strength of the economy. A dramatic case in point arose in early 1985, when the 1984 fourth quarter growth rate of real GNP was estimated at 4.3 percent. The figure was subsequently revised downward to 1.5 percent, and roughly two-thirds of the revision was attributable to corrections in the timing of exports and imports.

2. GROWTH OF THE SERVICE SECTOR

Existing data have not been adequate to keep pace with the changing composition of jobs in the U.S. economy. In 1969-1986, employment in goods-producing industries rose by 2 percent, while jobs in the service sector increased 63 percent. The service-sector's share of total nonagricultural payroll employment rose from 65 percent to 75 percent over this period.

Information on output, employment, hours, and earnings are classified by industry in accordance with the Standard Industrial Classification (SIC) code, as a study prepared last year for the Committee noted, the industry definitions used in the SIC code "profoundly influence the results of industrial analyses" and "maintaining an adequate code is of the utmost importance." Last revised 15 years ago in 1972, the code emphasizes goods-producing industries over service industries to a degree inconsistent with current realities.

Of the 1,200 individual categories included in the SIC code, 46 percent are in manufacturing, despite the fact that manufacturing today accounts for less than 20 percent of total employment. In the services area, in contrast, disparate establishments are grouped together in much broader categories and a number of significant new industries, for example, computer software producers, do not have separate SIC categories.

The SIC code is now under revision, after an unusually long delay caused by budget cuts in the early 1980's, but it will be several years before the employment data reflect the changes. Until then, the SIC code will continue to reflect the structure of the economy as it existed nearly 20 years ago.

The Committee has identified other areas of acute concern:

- At the Internal Revenue Service, the Statistics of Income Program has suffered deep reductions in recent years. This program will be essential to provide the data necessary in evaluating the impacts of the Tax Reform Act of 1986.
- At the Federal Trade Commission, the collection and publication of information on mergers and acquisitions were discontinued in 1982, just as the takeover phenomenon developed. As a result, only a private firm provides this crucial data, and it is more limited than that once published by the FTC.
- At the Department of Agriculture, the accuracy of crop predictions is now being questioned, and data are not available by states for the Farm Costs and Returns Survey, which provides information at the farm level on farm costs, assets, debt, and various components of the balance sheet.

3. THE FEDERAL ROLE

The Administration has repeatedly taken the position that to a significant extent the private sector can and should assume the responsibility for providing statistical information. Sidney Jones, Under Secretary of Commerce for Economic Affairs in 1983-1985, took issue with this position, telling the Committee in hearings last year that:

> The Federal Government should gather, compile, publish, revise, and preserve the core statistics necessary to create a comprehensive, logical, objective, and continuous information system. Individual government agencies, academic institutions, trade and professional associations, and private companies do not have the data collection authority or capabilities to perform these important functions, even though they are the actual sources of much of the information collected and they naturally develop many specific statistics and analytical reports.

Over the past six years, the labor force has grown more than 10 percent, real GNP has risen by 15 percent, and import volume has increased more than 51 percent. These figures are illustrative of the growth in the statistical system's work load, as determined by the size and variety of economic phenomena to be measured. In addition, the number of important uses for economic statistics has increased. Failure of the Federal statistical system to keep pace with the rapid and fundamental changes in the

U.S. economy will inevitably make private decisionmaking more difficult and complicate further the task of dealing effectively with pressing economic problems.

Spending on all U.S. statistics programs accounts for less than two-tenths of one percent of the Federal budget. What constitutes very minor savings in terms of the Federal budget can have a crippling effect on existing vital statistical programs, and could make it impossible to develop the new programs necessary to keep pace with the rapidly changing economy. Other nations are much less cavalier than the United States in their respect for a national statistical base. Modern statistical programs in Japan were established only after 1945, yet Japan today has a National Statistics Law and a month-long national celebration in honor of statistics; last year's theme was "Statistics are the beacon of a happy life."

Over the past several years, too little attention has been paid to the need for providing the accurate, comprehensive, and timely information on which critical decisions in both the private and public sectors depend. The Federal statistical base must be strengthened to develop, maintain, and disseminate the statistical data essential to a changing economy.

CONCLUSIONS

Three conclusions may be reached with regard to our statistical program. First, as former Under Secretary of Commerce Sidney Jones stated, the Federal Government has a responsibility to maintain the core statistics necessary for a comprehensive information system. Second, maintenance of the quality of our data will require adequate funding of our statistical agencies. Third, in addition to maintaining the quality of current statistical programs, statistical research programs must be strengthened and new statistics reflecting emerging developments in the economy must be developed.

ADDITIONAL VIEWS OF SENATOR WILLIAM PROXMIRE

The Joint Economic Committee's Annual Report does an excellent job of outlining the problems facing our economy. It paints the picture of an economy living for today while squandering tomorrow's opportunities. Unfortunately, that is an accurate picture.

Where do we go from here? Many of the problems identified in the Report can be traced, directly or indirectly, to dissaving by the Federal Government. The national debt went from $1 trillion to $2 trillion in about five years. It may well exceed $3 trillion before this decade ends. This orgy of spending is unparalleled in American history.

I can see no evidence that his trend has changed. Congress passed the Balanced Budget and Emergency Control Act of 1985 and the 1986 Federal deficit promptly reached a new record high of $221 billion. That Act set a target for the 1986 deficit of $172 billion; we will be fortunate to meet that target by 1988. The $108 billion target for 1988 is unreachable unless Congress and the Administration change their ways.

There is little or no evidence that such a change is in prospect. Spending pressures continue to build. The Strategic Defense Initiative, the Administration's highest priority, could cost trillions of dollars. The Defense Department now has about $300 billion in the bank, unspent but already appropriated by Congress. That money will be spent over the next few years. The Report itself identifies a number of domestic needs, which will be costly to meet.

Meanwhile, the fact that interest rates have dropped has disguised a ticking time bomb in the budget. That bomb is the unavoidable necessity to pay interest on the national debt. If interest rates increase even slightly, a distinct possibility, all of our efforts to reduce the deficit could come to naught. For example, the Administration has proposed spending cuts of about $15 billion in its FY 1988 budget. If interest rates increase by about 1.5 percent, roughly to the level they were in February 1986, then the additional costs of paying interest on the national debt would cancel all the Administration's proposed spending cuts. If we face some type of supply-side shock—a rapid increase in oil prices—and interest rates jump three or four points, then we would have to spend roughly another $30 billion or more merely to pay interest. I cannot overstress to my colleagues the dangers inherent in this situation.

We are in a race to see if we can reduce the deficit to a less dangerous level before the next recession hits. If we lose that race, the deficit could increase to the $300–$400 billion range, and the national debt would truly be out of control. This Nation would then face economic problems akin to those faced by some Third World countries. Our living standards would hit the skids and the social turmoil would be shattering.

The odds of such a scenario taking place are small but increasing. A near-term recession would increase them enough to be really worrisome. To avoid this possibility, we should first reduce the Federal deficit. To the extent that we do need to spend more on selected programs, we should force ourselves to spend less on other, less important programs. The revenues we raise should be dedicated to reducing the deficit.

We face extraordinary risks and opportunities over the next few years. Unless we reduce the Federal Government's dissavings, we increase the risks and miss the opportunities. Making such a reduction should be our first priority.

ADDITIONAL VIEWS OF SENATOR LLOYD BENTSEN

I congratulate Chairman Sarbanes and the Majority staff of the Committee for producing a comprehensive Report. It raises a number of issues and provides a provocative perspective on the economic challenges we face. These Additional Views will elaborate my position on several of the economic questions confronting the Untied States.

Deficit Reduction Targets.—As the Report notes, meeting the deficit target of $108 billion for Fiscal Year 1988 will be difficult because economic growth has slowed in the last two years. But I am not yet convinced that delaying progress toward that goal will unduly jeopardize economic growth. Moreover, the deficit reduction target should be achieved on the spending side and in a bipartisan fashion with active support and cooperation from the White House.

Third-World Debt.—The dramatic rise in U.S. Government debt since 1981 has been partly financed with foreign capital inflows. To that extent, the budget deficits may be crowding out investment in Third World nations and jeopardizing their efforts to service their own international debt. Reducing the Federal budget deficit will reduce that phenomena directly and reduce Third World service obligations through lower interest rates, as well. Moreover, the interests of creditors and debtors alike would be enhanced if the current account surplus nations of Japan and Germany would divert some of their promised increase in domestic demand toward Third World goods. These macroeconomic and trade steps may avoid the need to establish a special international multilateral institution as suggested by the Report.

Labor.—The Report correctly notes that the Administration's dislocated worker initiative is overdue and welcomed. Expansion of retraining and relocation assistance beyond the White House proposal should await assessment of the new proposal's success. In addition, expansion of the Employment Service is one of many options which should be considered to improve labor market information and accelerate the return of valuable and experienced men and women on layoff to the work force.

Agriculture.—The Report criticizes the export focus of agricultural programs. I disagree. American farmers and ranchers are the most productive in the world. We have a comparative advantage in their products. The failure of agricultural exports to grow apace in recent years has been a failure of trade policy to eliminate unfair trade barriers confronting U.S. agricultural exports abroad. Foreign government production subsidies, import barriers, and export subsidies have increased dramatically. European sugar beet farmers receive over three times the world price in export subsidy payments, for example. And trade barriers in Japan raise the price of many citrus and rice imports to four times world levels. The failure of our farms programs in recent years reflects in part the failure of our trade policy. And reforming trade policy to promote free trade is one of the most effective steps we can take to improve American agriculture.

Energy.—The Report correctly notes the rising dangers of oil dependency. The abrupt price movements engineered by the Organization of Petroleum Exporting Countries (OPEC) since late 1985 have crippled our domestic energy industry. And OPEC's demonstrated willingness to permit continued price volatility will prevent adequate investments in exploration and drilling sufficient to stabilize future domestic oil production. As a result, we face a future of eroding domestic production and climbing demand, with the widening gap filled with imports.

The most recent data for 1987 show that domestic crude and natural gas liquid production is off nearly one million barrels compared to the comparable period last year, while demand is some 2 percent higher. As a result, oil imports this year are averaging 6.3 million barrels per day, up 20 percent from 1986. Foreign oil is now providing 39 percent of domestic consumption, compared to 27 percent little more than a year ago. And groups ranging from industry organization to economic forecasting firms to the Congressional Budget Office are predicting that oil production will continue falling and that dependence will exceed 50 percent by 1990. Chase is forecasting 30 percent of stripper wells to be shut-in by then as well. And Dr. William Fisher of the University of Texas has noted that the giant Prudhow Bay field will begin declining in 1988 by as much as 200,000 barrels per day. Alaskan production boosted overall U.S. production in the 1980's but it will soon begin to exacerbate the production decline.

Rising dependence has alarmed some in the Administration. Former Energy Secretary and current Interior Secretary Hodel has said that "people will be sitting in gas lines anytime within the next two to five years," with OPEC back "in the driver's seat." Moreover, he has noted that an energy crisis like 1973 is "almost a certainty" without a recovery in domestic oil production. These fears are warranted. Higher oil prices in the 1970's and early 1980's reduced worldwide oil demand by seven million barrels per day while increasing non-OPEC production by six million barrels per day. Awash in oil, world prices declined. OPEC's stranglehold on world oil markets was loosened with its own production ebbing to 16 million barrels in 1985 from 31 million barrels in 1973. But that stranglehold will reemerge in the future as price volatility continues to shrink non-OPEC output. OPEC is the only major source of oil to offset these production declines and meet rising oil demands. Indeed, OPEC's production expanded a sharp 16 percent to 18.6 million barrels last year. And the combination of rising demand and falling production will increase U.S. imports by four million barrels at the end of this decade. Similar trends elsewhere will cause OPEC production to soar in the years immediately ahead, dramatically increasing the probability of oil price shocks and embargoes.

This grave outlook jeopardizes domestic economic prospects and the indepenedence of American foreign policy. It raises considerable national security concerns, as well, which have not been matched by Administration energy policy. Reducing energy R&D

outlays and abandoning vehicle fuel efficiency standards as the Administration has done magnifies rather than reduces our alarming dependence on insecure OPEC oil.

The Administration must join with Congress to craft a bipartisan national energy policy designed to limit U.S. oil dependence. I have proposed legislation designed to establish such a policy, entitled the "Energy Policy and Security Act." It is designed to limit dependence to 50 percent of domestic demand. This legislation does not mandate any specific action by the President to cap imports. Rather, it would require that he examine oil demand, supply, and import trends, and propose effective and far-reacing steps to cap imports should they threaten to exceed one-half of domestic production. Other approaches may be merritorious, as well. But the crafting of an effective and thoughtful national energy policy to minimize the dangers posed by imports to national security is an urgent task which cannot be done by Congress alone. It will require presidential leadership.

ADDITIONAL VIEWS OF HON. AUGUSTUS F. HAWKINS

I would like to commend Senator Sarbanes, the JEC staff, and the other Members of the Committee for presenting a clear and comprehensive review and analysis of the state of the American Economy. I applaud the format the Chairman uses in the Report, for it makes it easy for all to understand how each element of the economy has impacted our overall capacity for growth and ability to meet the challenges of domestic and international markets. Such analysis will make an important contribution to our current economic debate.

While the Chairman mentions the need for more effective presidential leadership and the need for a serious effort to fashion a workable package of expenditures and revenues to support national priorities, this Report does not take the next step and specifically recommend what those programs and policies should be. While I believe we should be presenting a broad analysis of short-term and long-term trends, the Joint Economic Committee should not shy away from making specific recommendations on what programs the Congress should be promoting to bring about full production, full employment, and price stability.

As pointed out in the Annual Report, the President's Economic Report did not submit an annual long-range plan designed to reduce the unemployment rate to 4 percent within a period of five years, as required by the Full Employment and Balanced Growth Act of 1978. I believe this Committee should be submitting such a plan in this Annual Report. We lose an important opportunity to make a meaningful contribution to the coordination of economic policy by not putting forth our own specific recommendations and policy alternatives.

Statute requires the reduction of unemployment and attainment of price stability to be the central focus upon which our economic policy decisions turn. I urge both the Administration and a majority of the Congress to provide the political will to implement this important policy directive.

MINORITY VIEWS

REPUBLICAN JOINT ECONOMIC COMMITTEE ANNUAL REPORT

I. INTRODUCTION

The current economic expansion is well into its fifth year. Dr. Walter E. Heller of the University of Minnesota and Dr. Richard Rahn of the U.S. Chamber of Commerce agree that real gross national product growth during 1987 (year-over-year) will be 3.0 percent. Only slightly more optimistic is the Administration's forecast of 3.1 percent. A survey of 41 economic forecasters provided by Blue Chip Economic Indicators shows a real GNP growth consensus of 3.4 percent for 1988, a marked improvement over 1987. Virtually no one predicts a recession in either 1987 or 1988. The "Blue Chip" forecast for the unemployment rate in 1988 is 6.6 percent, a decline from its forecast of 6.9 for 1987. According to the same economic forecasters the consensus is that inflation and interest rates will remain low and under control. The Joint Economic Committee's Republican staff supports the consensus findings for 1988 of these 41 independent forecasters.

The economy appears to be on a path of stable growth. We're comfortable with the current low rate of inflation, hopeful that interest rates will continue to decline, optimistic that employment opportunities will continue to improve, and confident in this Nation's resilient, innovative, and diversified economy.

This is not to say that all is well. Because our economy is dynamic and relatively free of governmental control, it permits and generates change. Change causes uncertainty, which fires the political furnaces. But governmental intervention must not defy economic principles of the free market upon which long-term growth depends.

The United States is not deindustrializing nor are geographic regions of it doomed to economic extinction. A tighter labor market will lead to greater earning opportunities, particularly for minorities and new immigrants who will be making up an increasing proportion of the Nation's labor force. Educating and training this labor force will be essential—not for the purpose of placating the social conscience, but for U.S. economic well-being. U.S. business decisions regarding investment, research and development, and productivity will pose challenges as economic growth becomes increasingly dependent upon successfully competing in the global marketplace. Unless our policies are mutually supportive of U.S. labor and capital, we face the danger that the world may have little use for either.

The greatest economic challenge facing the 100th Congress—"The Centennial Congress"—is reducing the Federal deficit. The deficit-reduction program of Gramm-Rudman-Hollings, which calls for $36 billion annual reductions in deficits, must be minimum adhered to. Achieving a reduction of the deficit to $108 billion in fiscal 1988 must be pursued with all vigor. Like the patient suffering from a life-threatening disease, we must keep up the treatments. Similarly, we must not renege on tax cuts pledged in the 1986 Tax Reform Act. Regarding monetary policy, we believe that the Federal Reserve has maintained the right balance, achieving price stability along with continued economic growth.

Over the longer term, there are several major forces which are influencing the direction of the U.S. economy. The issue of "competitiveness" will receive much attention from this Congress, but we caution against overly active political intervention in the economy. The ability of our market-based economic system to react and adjust to a global marketplace will prove to be our best weapon in the competition for world markets. At home, there is a desperate need to rethink national policies dealing with welfare, Federal regulations, and agriculture. This report presents an agenda by which the Joint Economic Committee can fulfill its mission to lead the Congress in analyzing and debating these issues.

II. ECONOMIC OUTLOOK

The economy has been growing since late 1982. Although this is an extremely long expansion by historical standards, 1987 shows every sign of being another good year.

The Administration's official forecast says that real gross national product will grow 3.1 percent (year over year). This is slightly higher than the consensus of private economic forecasters but we believe that the chances are excellent that the Administration's forecast will prove to be accurate.

Interest rates are expected to continue to decline slightly, largely due to growing confidence that inflation will not be a problem for the foreseeable future. Furthermore, the economy's moderate growth rate suggests that an investment boom is not likely to push up interest rates. The ease with which investment funds cross national borders also makes a run up of U.S. rates unlikely.

Inflation in 1987 will probably be around 3.5 percent (average Consumer Price Index, year over year year), which is toward the upper end of an acceptable range of 0 to 4 percent. At that level it will be somewhat over 1986's 1.9 percent rate, which was the lowest in decades. These favorable developments on the financial side owe much to the successful monetary policy carried out by the Federal Reserve during the past several years.

The unemployment rate for all civilian workers dropped in 1986, and it is expected to average under 7 percent during 1987. As discussed later in this report, long-term demographic trends are reducing the growth of the labor force, which will result in somewhat tighter labor markets.

Housing starts may equal their sustained performance during 1986, which were strengthened when mortgage interest rates dropped below 10 percent for the first time in almost a decade. Nineteen eighty-seven should also be a good year for housing, with about 1.8 million starts likely, especially if mortgage rates continue to hold at less than 10 percent.

Auto sales in 1987 will be somewhat less than the 1986 total of 11.3 million units. For the U.S. economy, the import share will be the crucial variable. This is uncertain. On one hand the fall of the dollar will tend to raise import prices and promote the market share of American made cars. On the other hand, foreign sellers may be faced with a surplus of cars due to the rising popularity of American built cars, which would indicate the need for foreign producers to cut prices.

Why Does the Expansion Continue?

Economic growth this year will be helped by an improvement in the trade balance, brought about by the decline in the foreign exchange value of the dollar. Foreign economies will, by and large, be strong enough to increase their demand for U.S. exports. Our monetary policy has achieved the appropriate degree of expansion, and it is clear that the Federal Reserve is alert to any warning signs from the economy, should they occur.

The economic situation is not without potential problems. The fall in the dollar may lead to higher interest rates if it affects the willingness of foreign investors to hold U.S. assets. Business investment appears to be weak, at least during the early months of 1987. Both the farm economy and the energy-producing regions of this country have not recovered from their economic slumps.

Sometimes economic policy is itself the cause of economic problems. Economic expansions rarely die of old age; they succumb to bad policy. One potential danger is the possible passage of a protestionist trade bill. In January, the Blue Chip panel of economists strongly endorsed the statement by the Council of Economic Advisers that "international protectionism would be a burden on our economic life and a threat to our long-term economic prosperity." A 10-point-scale rating of 8.6 rejecting protectionism was among the highest that the Blue Chip survey has ever recorded on a public policy issue.

Some analysts worry that efforts to delay income until 1988, when tax rates will be lower, will slow the economy this year. We do not believe that this effect will be large. Because the greatest share of personal income comes from wages and other sources that are not easily deferred, delays in income receipts can be made only at the margin. Often these delays are only nominal (like an author delaying his contracted income for a week or two) and do not affect the actual level of economic activity.

Overall Economic Performance

Economic performance consists of more than just growth in gross national product. Low unemployment, low inflation, and low interest rates are of comparable importance. When viewed in this broader context, the economic policy of the Reagan Administration is clearly even more successful than when judged by growth alone. Even the most casual review of the data reveals that inflation and interest rates are far below the alarming levels they had reached at the end of the Carter Administration.

Is there any way to generalize about overall economic performance? Can we capture the essence of policy makers' success—or lack of it—in just one statistic?

A recent report by the Republican staff of the JEC attempted to do just that. In "Measuring Economic Performance," released late last year, we constructed an index of 10 widely used measures of economic conditions:

- Gross national product (constant dollars);
- Disposable personal income per capita (constant dollars);
- Fixed nonresidential investment (constant dollars);
- S&P index of stock prices;
- Productivity;
- Exports (constant dollars);
- Corporate profits (constant dollars);
- Consumer price index;
- Interest rates; and
- Unemployment rate.

The Federal deficit is not included because there is disagreement over its effect on the economy. Whatever its effect, it should be reflected in the values of the 10 variables that were selected.

These 10 variables were weighted by their relative importance in assessing economic conditions, as judged by the Blue Chip panel of economic experts. The resulting statistic—the Economic Performance Index (EPI)—was computed for each year from 1953 through 1986. (For more details, see "Measuring Economic Performance," Joint Economic Committee, November 7, 1986.)

According to this broadly based measure of economic performance, the Reagan Administration has produced the greatest improvement during the 33 years that were examined. The actual level of economic performance was highest during the early 1960s, when growth was rapid, unemployment was low, and inflation was moderate. But the trend since then was downward until the reversal during the Reagan years, which has been quite remarkable.

New calculations, incorporating forcasts of the 10 variables for 1987, show that the overall record of the Reagan Administration is now the second best of any administration during the post-1953 years. It is behind Kennedy-Johnson, but slightly ahead of the Eisenhowever Administration and well ahead of Nixon-Ford. The Economic Performance Index for the Carter years is by far the worst of any administration, owing mainly to high interest rates, high inflation, and lackluster economic growth.

Summary

The economy has been growing since late 1982, and we expect growth to continue through 1987. The Administration's forecast of 3.1 percent real GNP growth (year over year) is more optimistic than the average of private forecasters, but we believe that the chances are excellent that this forecast will prove to be accurate.

Interest rates will continue to decline slightly, though prices will increase by about 3.5 percent (average CPI, year over year), somewhat over the very low rates experienced in 1986. The unemployment rate should stay under 7 percent.

Problems on the horizon include the falling dollar, which may lead to higher interest rates, and the continued weakness of the farm and energy sectors.

Overall economic performance during the Reagan years, according to our analysis, compares favorably with any since the early

1960s, thanks to the marked reductions in inflation and interest rates, plus the return to economic growth.

III. ECONOMIC TRENDS AND POLICY

Introduction

This chapter provides an overview of some of the more important micro trends that exert a strong influence on economic growth, present and future. The first to be discussed are the shifts in the composition of U.S. industry. The second section examines expected changes in the labor force and the opportunities that will present. The next section considers the determinants of improvements in productivity, particularly capital formation and technological innovation. The final section of this chapter examines the regional implications of economic growth.

Industry Composition

After countless articles detailing the rise of the service industries, it is hardly news that the service-producing sector is growing faster than the goods-producing sector of the economy. By now it must be common knowledge that this increase in services is not signaling the "deindustrialization" of the United State. The absolute decline in our industrial base that is implied by the term deindustrialization has not occurred and probably never will. Real output in manufacturing is at an all-time high, with investment at historically high levels.

In addition, there has been no significant decline in the relative importance of manufacturing output as the service sector has grown. In 1950, the manufacturing industries produced 24.9 percent of total GNP (excluding government services) and the service sector produced 51.8 percent. The manufacturing sector's share has remained fairly constant, except for cyclincal swings, and in 1985 this sector produced 24.4 percent of GNP.

During this same period, however, services experienced a substantial rise in output share of 11 percentage points. The relative gain by services was at the expense of the other goods-producing industries—construction, agriculture, and mining, but not manufacturing. Even during this period of relative decline, the real level of goods-sector output increased by approximately 150 percent during the 35 year period. Service output simply grew faster at 275 percent.

The only areas where there has been an absolute decrease in manufacturing is in employment. There are currently 9 percent fewer jobs in the manufacturing sector than there were in 1979, the peak employment year. The relative rise of the service sector is not a recent phenomenon. As seen in Table III.1, the shift toward services is evident at least as far back as 1959 and the BLS forecast for 1990 shows this trend continuing. Only the durable manufacturing industries are projected to experience sufficient employment gains by 1990 to achieve a relative gain in employment. Agriculture and the other goods-producing industries will continue to lose share, but the rate of decline appears to be leveling.

Even though the aggregate level of employment for the goods sector is currently rising, there are specific industries that will continue to experience declines. However, it is important to distinguish between two very different causes of employment decline: those caused by productivity improvements and those caused by declines in demand for the product. A recent study by Ronald Kutscher and Valerie Personick of the Bureau of Labor Statistics ("Monthly Labor Review," June 1986), examines the output and employment changes of 150 industries between 1969 and 1984. They consider three categories of change. Industries were both output and employment increased during the period, the first and largest category, comprise one-half of the industries studied. For virtually all of the industries in this category, the increase in output is greater than the increase in employment, implying gains in labor productivity.

TABLE III-1.—DISTRIBUTION OF U.S. EMPLOYMENT, 1959–1990

Industry	1959	1969	1979	1985	p1990
Total (thousands)	67,784	81,508	101,471	109,489	116,856
			Percent		
Agriculture [2]	8.2	4.4	3.3	2.9	2.7
Goods-Producing	31.8	31.1	27.6	24.2	23.8
Mining	0.9	0.6	0.7	0.6	0.6
Construction	5.8	5.4	5.8	5.7	5.3
Manufacturing	25.1	25.1	21.1	17.9	17.9
Durable	14.1	14.8	12.8	10.7	11.0
Nondurable	11.0	10.3	8.3	7.2	6.9
Service-Producing	60.0	64.5	69.1	72.9	73.5
Transportation, communication, and public utilities	6.3	5.7	5.3	5.1	5.1
Trade	19.9	20.5	22.0	22.8	23.2
Finance, insurance, and real estate	4.4	4.7	5.4	6.0	6.0
Services [3]	17.5	18.6	20.7	24.0	25.1
Government	11.9	15.0	15.7	15.0	14.2

[1] Includes wage and salary jobs and self-employed, as tabulated by Personick.
[2] The projections are the U.S. Bureau of Labor Statistics moderate growth figures.
[3] Includes private households.

Source: Valerie A. Personick, "A Second Look at Industry Output and Employment Trends through 1995," Monthly Labor Review (November 1985), table 1. (Updates provided by Personick).

In addition, the results show that:

> Among the goods-producing industries which are included in [these] growing industries are 4 of the 7 agricultural industries [food and feed grains, agricultural products n.e.c., forestry and fishery products, and agricultural, forestry, and fishery services], 2 mining industries [coal and chemical and fertilizer minerals], maintenance construction, and numerous manufacturing industries. Most of the latter on the list of output and employment gainers are durable goods industries, particularly those which are included in 1 of the 3 high-technology definitions developed earlier by BLS (p. 8).

The second category specified by Kutscher and Personick contains those 24 industries where output is increasing but employment is declining. The 37 industries in this grouping have most likely experienced gains in productivity that exceed the increase in demand. The industries in this goup include "[m]any of the food processing, textile, chemical, metal products, and industrial machinery industries . . ., as well as motor vehicles (p 9)".

The third group, which can be considered to be the declining industries, are those that have experienced declines in both output and employment during the 15 year period. The industry that dominates the list in output and employment loss is the blast furnaces and basic steel products industry. Other big decliners were also in the "basic" industries, such as iron and ferroalloy ores mining, rubber products except tires, and leather tanning and finishing.

The results from this study illustrate that while there does exist a group of troubled industries, there is no basis for concluding that the goods-producing sector or the manufacturing industries, in general, are in a state of decline. In fact, the industries in the first and second categories are growing in a positive manner, i.e., through productivity growth. What appears to be happening is a maturing process as the economy shifts away from those (relatively few) industries where it no longer has a comparative advantage. The decline of industries is not a new phenomenon (and there are laws designed to maintain vital defense industries).

The current situation in the manufacturing sector of increasing output and declining employment is similar to that experienced by the agricultural sector since 1950. For almost fifty years there has been an increasing spread between output and employment in agriculture indicating increased productivity, not sectoral decline. Improvements in agricultural processes significantly reduced the number of people necessary to produce any given level of output. This increased the labor available to the expanding manufacturing sector during the 1950s. The continuing upward trend in manufacturing output again demonstrates that the United States is not losing its manufacturing base. And the decrease in employment relative to output is an indication of increased productivity.

Two other forces combined with rising manufacturing productivity to increase the relative share of services: a large increase in the labor force and the end of the postwar global expansion (1948–1973). Labor force participation for women rose between 1973 and 1985 by 10.3 percentage points to the level of 54.7 percent. This along with the entry of the "baby boom" generation into the work force caused a significant rise in the labor force during this period. At the same time there was generally sluggish growth in world demand for manufactured goods, combined with increasing supply as many of the lesser developed countries established their own manufacturing sector.

The combination of falling demand for goods with a rising supply of labor would have had a very serious negative effect on the economy if the service sector had not expanded as it did. But in the last 15 years almost 30 million new jobs were created in the United States and over 95 percent of those were in the service industries. This performance is a strong contrast to the European experience of virtually zero employment growth over the same period. According to BLS projections this trend will continue, with 90 percent of the 16 million new jobs projected to occur by 1995 to be in the service-producing industries ("Monthly Labor Review," November 1985,

p. 26). Therefore, this relative shift toward services is not a flaw that needs to be corrected; it is the natural direction of growth in the economy.

Nor is the shift toward services signaling a decline of the middle class: employment growth has not been concentrated at the low and high extremes of the wage scale. As a recent Bureau of Labor Statistics study reports, it is the top two-thirds of the employment distribution that is increasing contrary to the "bipolarization thesis" espoused by some (McMahon and Tschetter, "Monthly Labor Review," September 1986).

In addition, some manufacturing firms are laying off white collar workers and contracting out to service firms to obtain the work previously done in house. This reduces manufacturing employment statistically, but it is not a structural shift from manufacturing.

The above discussion is not meant to imply that there is no bad-news component to the shift toward services. The worker dislocation that has occurred as a direct result of this structural change is not a minor problem, particularly since many of the declining industries are regionally concentrated. However, because the growth in the labor force is slowing considerably, the next 10 to 15 years should be a period of opportunity where both industries and individuals will attach a high value to training and retraining. The evidence is strong: Services will continue to comprise a growing part of the economy. Efforts to interfere with this long-term trend would be costly and of little effect. The only sound policy to pursue is one that is sensitive to the trauma of worker dislocation and one that allows the maximum flexibility for change.

Labor

After going through a period where the labor force grew rapidly, we are now entering a period of slower growth. Additions to the labor force are projected to be at the lowest rate since the 1930s. BLS predicts that by 2000 the growth rate will be down to 1 percent annually, owing mainly to decrease in the number of young workers. In 1985, workers aged 16 to 24 made up 20 percent of our Nation's work force, but by 2000 this percentage is projected to drop to 16 percent. In addition, even though labor force participation among women will continue to rise, the increase will occur at a decreasing rate.

The racial and ethnic composition of the labor force will also be changing. The proportion of minority youths in the labor market will increase and by 1990 one out of five new labor force entrants will be a minority youth. Immigrants too will significantly affect the future labor force as their numbers continue to increase at a rate faster than at any time since World War I.

These changes create both an opportunity and a challenge: The tighter labor markets will make possible a reduction in unemployment, particularly among groups considered to be disadvantaged, but only if sufficient training is provided so that those seeking employment have the job skills needed by the employers. The educational system must emphasize attainment of the basic verbal and analytical skills that form the basis for further learning. While employers will become increasingly willing to provide job-specific training as the pool of potential employees shrinks, the training process will be more successful if the employees already have these basic skills. Our educational system must prepare students to succeed in the economy.

In addition to improvements in our educational system, there are cultural and structural issues that must be addressed in order to take advantage of this "window of opportunity" to help groups with long-standing labor market problems. The Department of Labor is presently undertaking a major examination of these issues in its Work Force 2000 project. The study has identified three broad categories of policy goals they consider to be most important for the next 15 years:

> Promoting change.—A key ingredient for economic growth over the next 15 years will be a willingness by individuals, companies, unions, governments, and other institutions to adapt and respond to a rapidly changing economy. Individuals must learn new skills, organizations must be able to adopt new technologies and organizatonal systems, unions and managers must find new ways to relate to each other, and government must rethink historical ways of regulating, taxing, and promoting industrial growth. Because many members of our rich and aging society will be increasingly resistant to change, government policies should be designed to promote change by individuals and institutions.
>
> Increasing the numbers of qualified workers.—Slow labor force growth presents a serious potential constraint on American economic growth and international competitiveness. To maintain our position in the world, including our economic preeminence and military strength, we must find better ways to employ the disadvantaged, immigrants, and women who have not been able to contribute fully to our economy.
>
> Enhancing the skills of the work force.—As the world economy becomes more competitive and intergrated, and increasingly focused on services and information tasks, [our] economic success will depend to a greater degree on our human capital. By the year 2000 there will be few high-wage, unskilled jobs; industries that require only unskilled labor, and jobs that require only basic human skills will increasingly be done abroad. High American wages will be paid only to those whose knowledge or skills give them as edge in national and world labor markets. As a matter of equity within American society, and competitiveness around the globe, more attention must be paid to improving the skills of all segments of the U.S. labor force.

The research of Work Force 2000 is continuing as the Department of Labor begins examination of specific policy options in achieving the above goals. This project is a significant initiative because it questions which policies should be undertaken to take advantage of the coming demographic changes. Too often policymakers are constrained by both time and money to deal only with problems of the present. Projects such as this, which are investments in the future, recognize the gains that can be realized by preparing for change as opposed to trying to prevent it.

Productivity

One goal of an economic system is to increase the average standard of living by increasing the quantity and quality of goods and services produced. It is this absolute increase that allows us to afford more of everything from better cars to improved social programs. Economic growth is the term usually associated with this notion of potential improvements in "well-being". The primary engine of economic growth is productivity. The ability to produce more and better goods and services using fewer inputs is fundamental to increasing economic growth.

The forces that influence productivity growth are diverse, but there is a general consensus that investment in plant and equipment, human capital, and research and development are the major categories. Even within these categories are extremely diverse investments, and there is no reason to expect spending on different investments to have an equal impact on productivity growth. While we can identify the factors that influence the productivity growth rate, the strength and timing of their impact on productivity is highly variable. These factors tend to interact with one another and their net impact on productivity is felt only after a period of time. Therefore, to attribute the success or failure of attempts to increase these measures on any one factor is usually not accurate and fails to recognize the complexities of a free market economy that produces a total output of our $4 trillion yearly.

Not only does the composition of investment affect its eventual effect on productivity; it will affect the timing also. For example, the impact of changes in the quality of education at the grade school level may take many years before productivity is improved, resulting in a better prepared work force. In contrast, the replacement of an old machine with a new improved one may have an immediate level.

Aggregate labor productivity for the entire business sector (i.e., everything but agriculture and government), while increasing, is not increasing very quickly. The average increase for the current business cycle (1979–85) has been just over 1 percent annually. This aggregate hides some very significant variations that occur among the components of the business sector. One of these components, manufacturing, has been experiencing substantial increases in productivity during this period. The annual increase for 1985 was 4.4 percent and the 1986 increase should be between 2.5 and 3.5 percent.

Manufacturing productivity should continue its increase as real capital expenditures, particularly for equipment, continue the strong growth they have shown during this recovery. This investment growth is likely despite the 1986 tax revision that largely eliminated the investment tax credit, retroactive to January 1, 1986.

The low growth in business sector productivity is largely due to low estimates for its component service sector productivity. This slow growth may, in part, be due to measurement problems. These problems are not new, but the increasing size of the service sector has made the measurement problems of services more significant. Because productivity is a measure of output per unit of input or input group, it is important to have a good measure of both components. It is difficult to derive an adequate measure of service output because it is likely to be an intangible, such as legal advice, and may consist of many discrete parts that can be consumed in different combinations. For example, an advertising agency can produce the ad concept alone, leaving actual production to a video agency, or it can produce both. A bank offers an array of services, from accepting demand deposits to devising investment plans; a customer may use one or many of these services during a single visit. Measuring productivity improvement in such diverse and abstract activities is extremely difficult.

Government policies that support investment, and thus productivity growth, fall into two categories. In the first group are those investments that the government undertakes itself through direct expenditure. An important component of this category is investment in infrastructure. Roads, bridges, and sewers have an essential, but largely unmeasurable, positive effect on productivity growth.

The effects of other types of government investment, such as in basic research and development or education, are more easily measured. These types of expenditures support productivity improvements by increasing our collective store of knowledge. Additional programs in several of these productivity improving categories have been given high priority status in the President's current budget proposal. Even with the need to cut Federal expenditures, the Administration recognizes the importance of this government function. Its budget proposal includes provisions for:

funding basic biomedical research;

$200 million increase for compensatory education for educationally disadvantaged children; and

increases in funding for clean coal technology demonstrations, as well as research on acid rain formation and its environmental effects.

Policies in the second category are those that affect productivity by benefitting the economic environment in a general way. These are policies that provide for the attainment and maintenance of a stable economy make investment generally more attractive. Businesses invest less if they cannot predict with any confidence economic conditions for the next quarter or next year. Runaway inflation and extremely high interest rates send mixed signals to producers and encourage a wait-and-see attitude that leads to a stall in investment. The current economic environment, which features an inflation rate of about one percent for last year (December 1985 to December 1986) and a prime rate of interest that is less than half of what it was five years ago, is an important force in extending the current expansion.

Regional Differences

At the national level, economic growth is generally measured by changes in real gross national product (GNP). This chapter has concentrated on some of the important determinants of economic growth at the national level. But a step back from this very important aggregate concern is the equally important consideration of how this growth is allocated among sections of the country. If economic growth is highly concentrated geographically, that would have very different policy implications than a more spacially dispersed growth pattern.

Unfortunately, there is not a state or regional counterpart to GNP, therefore another proxy must be chosen. The Federal Reserve should have value-added data by Federal Reserve District which divides the country into 12 regions. One output measure that is commonly used is personal income. Another approach is to consider an input measure such as employment. A third option is income per capita, which takes into account the welfare aspect.

There is also the question of regional breakdown. Recognizing that there is no "best" level of aggregation, this section will explore regional growth issues using the census regions and divisions. Choice of any regional level is arbitrary.

States aggregated into any regional breakdown will exhibit differences. For example, while both Connecticut and Maine are usually grouped together with the New England states, Connecticut has an average income per capita that is 30 percent above the national average and Maine's average is 14 percent below the national. States themselves also are not homogeneous; there may be differences among metropolitan and nonmetropolitan areas, coastal and noncoastal areas, etc. Consider Florida, which has an unemployment rate approximately equal to the national average. Recent estimates of unemployment rates for selected metropolitan areas of the state range from 4.0 percent in Gainesville to 14.8 percent in the Lakeland-Winterhaven area.

Two different types of regional patterns are described in this section, one short-term and the other long-term. The variations in intra-cyclical income growth rates are an example of the short-term pattern. For periods of four or five years it does appear that parts of the country are favored over others. However, looking back over several business cycles we will see that the periods of dominance are short lived. Other regional patterns appear to indicate long-term trends. The trend toward convergence of regional income per capita and the shift in population and jobs from the North and Midwest to the South and West are examples of these movements, which will probably continue.

Personal Income

In order to exclude cyclical effects, growth rates for real personal income were examined for the four most recent business cycles (peak-to-peak). Table III-2 lists the real annualized growth rates and the rankings for the nine census divisions during each of the cycles. There is considerable variation in the growth rates not only among periods, but also among divisions in the same period. The movement in rankings indicate that each business cycle seems to favor a different section of the country. Strong performance in one cycle does not carry over into the next because the underlying conditions affecting growth change from cycle to cycle.

TABLE III–2.—GROWTH IN PERSONAL INCOME BY REGION ANNUALIZED REAL RATES OF CHANGE (1982 DOLLARS)

	1958–69		1969–73		1973–79		1979–85	
	Percent change	Rank	Percent change	Rank	Percent change	Rank	Percent change	Rank
New England	4.6	6	2.9	8	1.7	8	3.3	2
Middle Atlantic	4.1	9	2.5	9	0.8	9	2.3	6
East North Central	4.2	7	3.5	7	1.9	6	0.3	9
West North Central	4.1	8	5.7	4	1.8	7	1.1	8
South Atlantic	5.8	1	6.3	2	3.0	5	3.5	1
East South Central	4.8	5	5.7	3	3.4	4	1.4	7
West South Central	4.9	4	5.5	5	5.3	1	3.1	3
Mountain	4.9	3	7.8	1	4.9	2	2.9	4
Pacific	5.4	2	3.5	6	4.9	3	2.8	5
United States	4.7		4.2		2.7		2.2	

CENSUS REGIONS AND DIVISIONS

Northeast

New England.—Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut.

Middle Atlantic.—New York, New Jersey, and Pennsylvania.

MIDWEST

East North Central.—Ohio, Indiana, Illinois, Michigan, and Wisconsin.

West North Central.—Iowa, Missouri, Nebraska, Kansas, Minnesota, North Dakota, and South Dakota.

SOUTH

South Atlantic.—Delaware, Maryland, District of Columbia, Virginia, West Virginia, North Carolina, South Carolina, Georgia, and Florida.

East South Central.—Kentucky, Tennessee, Alabama, and Mississippi.

West South Central.—Arkansas, Louisiana, Oklahoma, and Texas.

WEST

Mountain.—Montana, Wyoming, Colorado, Utah, Idaho, Arizona, Nevada, and New Mexico.

Pacific.—California, Hawaii, Washington, Oregon, and Alaska.

The period with the least variation among divisions is 1959–69. The combination of the war in Viet Nam and the Great Society programs created an overheated economy, with temporary growth that was paid for by the inflation later on. The 1969–73 business cycle featured a booming agricultural sector—real net farm income doubled during this four year period. During the next cycle, 1973–79, it was the energy-producing states that experienced the strongest growth, while the energy-dependent states suffered. Problems were particularly severe in the industrial Northeast. In the current cycle, the New England and Middle Atlantic divisions have succeeded in turning their economies around by creating favorable business environments, while the fall in energy prices and the loss of agricultural exports have limited growth in the other regions.

Employment

Employment growth, like that of personal income, does not occur at the same rate in all sections of the country. The South and West have been growing relatively faster than the rest of the country.

Chart III-1 shows the change in nonagricultural employment by census division over the last two business cycles. Over half (52.5 percent) the nonagricultural jobs in the country were in the Northeast and Midwest in 1973, but this was reduced to 47 percent by 1985. This shift is the result of higher rates of job formation in the West and South rather than a decline in employment in the Northeast and Midwest. Only the East North Central region actually experienced a loss in employment in one of the periods (1979-85).

There has been a substantial shift in unemployment rates between the regions. As seen in Chart III-2, the rates of unemployment went from being the highest in the Northeast in 1975 to the lowest in 1985. Unemployment rates also show a great deal of variability within regions.

CHART III.1

DISTRIBUTION OF NONAGRICULTURAL PAYROLL
EMPLOYMENT BY REGION

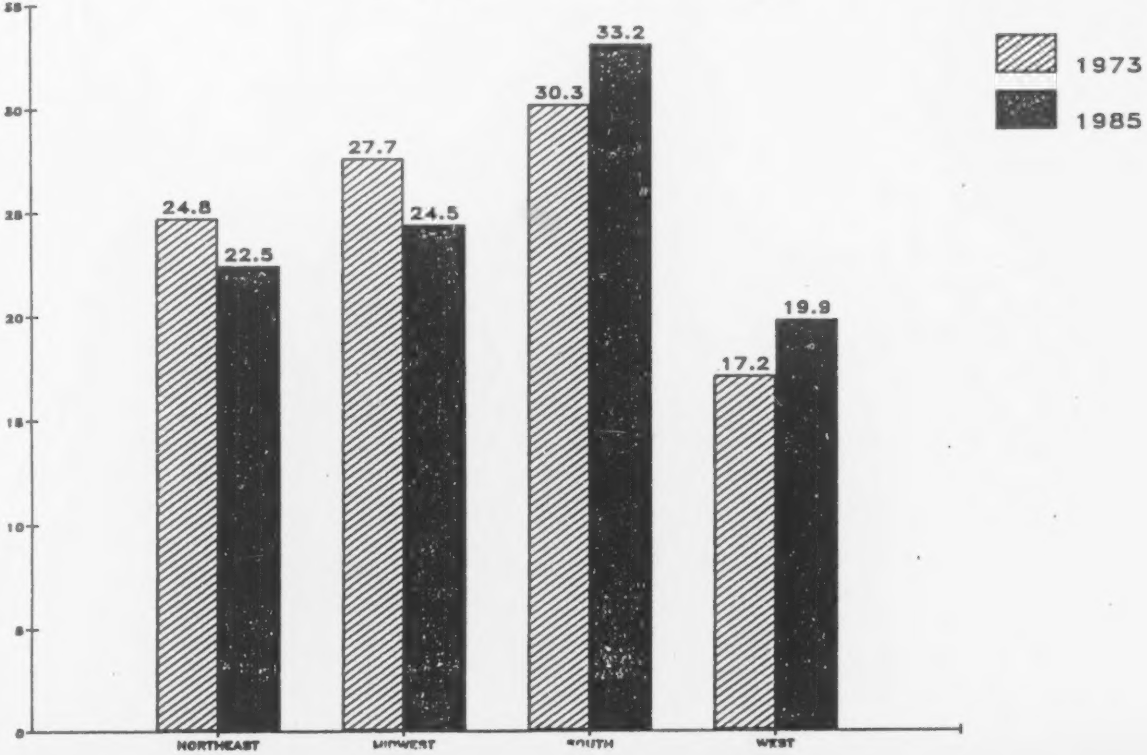
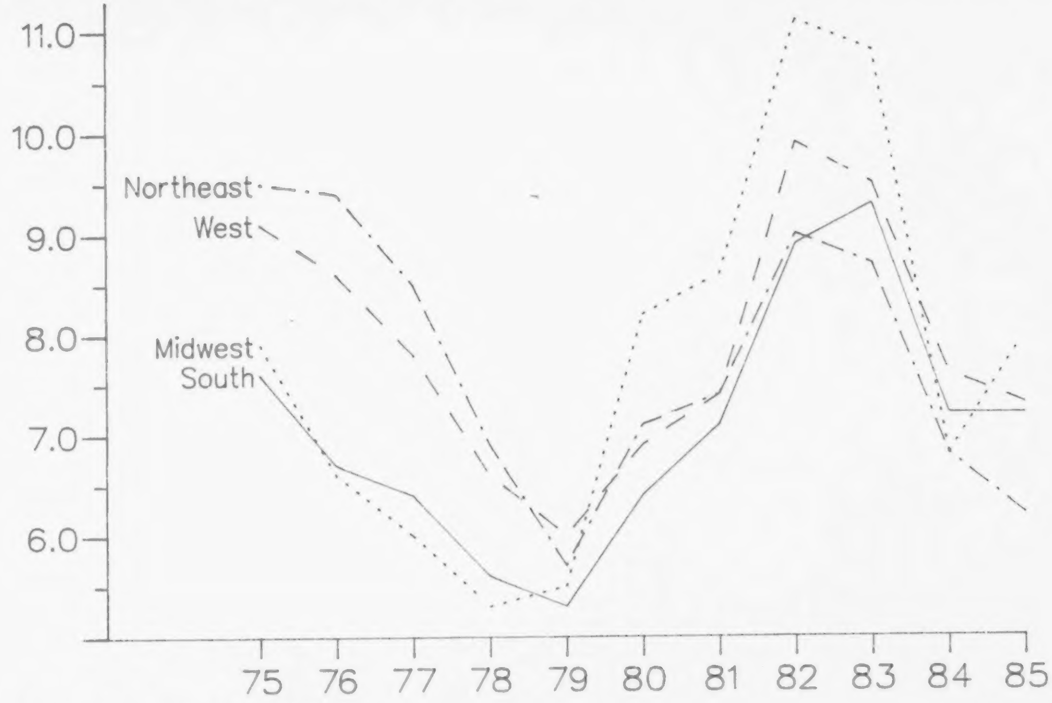


CHART III.2

UNEMPLOYMENT RATES BY CENSUS DIVISION



Source: Bureau of Labor Statistics

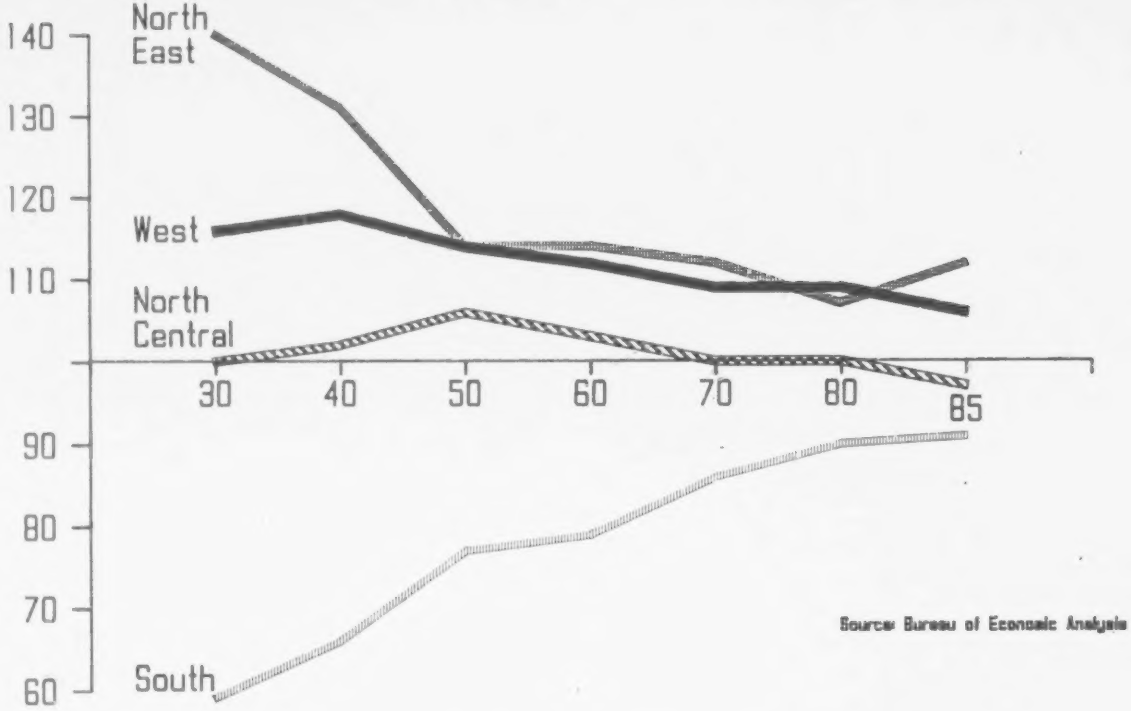
Personal Income Per Capita

As would be expected, the ability of capital and labor to move between sections of the country has led to a lessening in regional differences in personal income per capita (PIPC). Yet as would be expected, labor mobility is not perfect and the convergence has not been a smooth, uniform process. Regardless of these variations, it is evident from Chart III–3 that there is a long-run trend toward convergence of PIPC. In 1930 the PIPC was 139 percent higher in the Northeast than in the South, but by 1980 that percentage had dropped to 18 percent. Although the differential has risen slightly since 1980, there is no reason to believe that this is signaling a change in the long-run trend toward equality.

As the regional averages converge, it becomes more likely that variations in one of the component divisions can cause deviations, such as the one evident in the recent data. Looking at Chart III–4, which shows the PIPC as a percent of the U.S. average for the census divisions, it can be seen that the recent deviation at the regional level is caused by the increase in relative PIPC in the New England region. This increase, in turn, is driven by increases in two of the six New England states, Connecticut and Massachusetts. The relative increase of the New England division is approximately the same as the decrease in the West North Central division that occurred between 1948 and 1956. That deviation from the trend toward convergence did not cause a variation at the regional level because the variance of the regional level was much higher at that point. In other words, observed variation among regions is most likely statistical artifact, devoid of policy implications. In fact, preliminary indications are that the 1985 deviations have begun to reverse.

CHART III.3

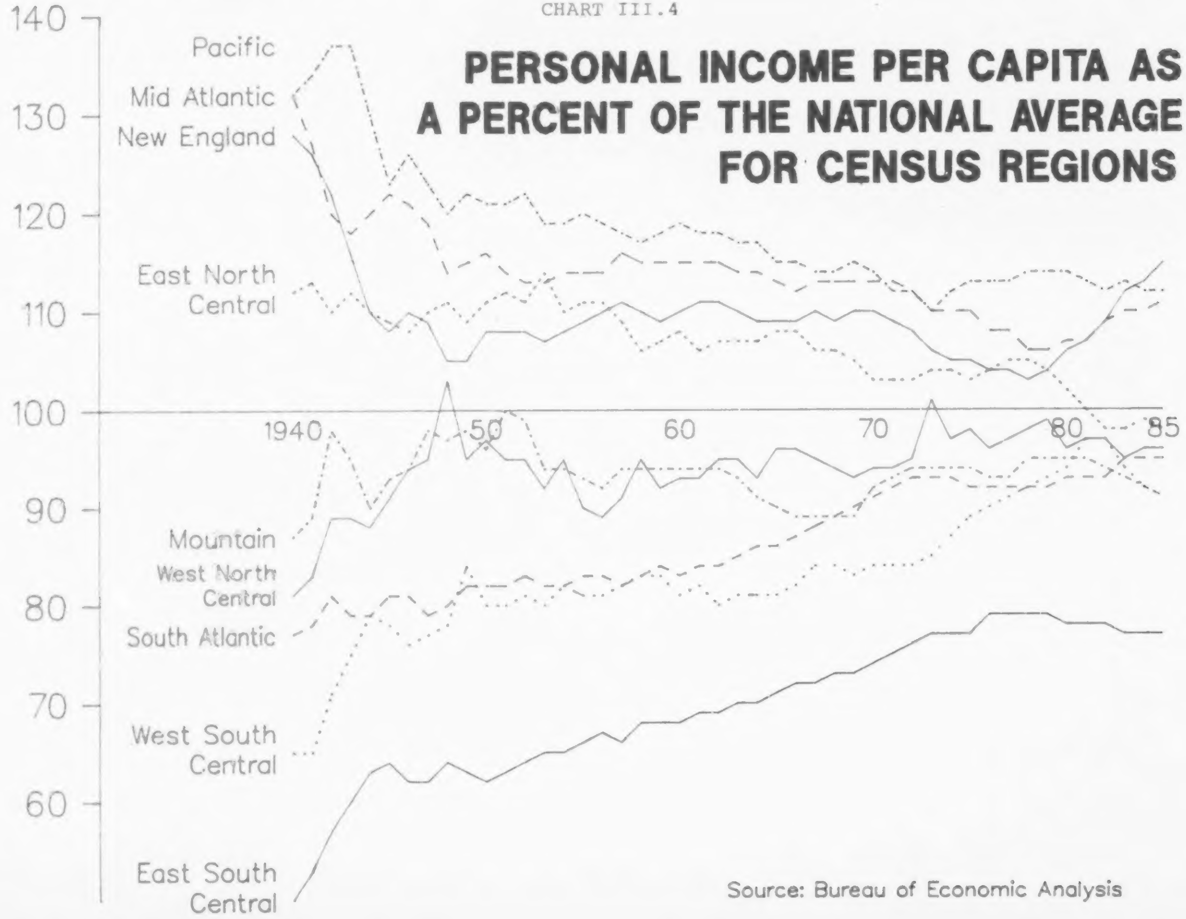
Personal Income Per Capita as a Percent of the National Average for Census Divisions



Source: Bureau of Economic Analysis

CHART III.4

PERSONAL INCOME PER CAPITA AS A PERCENT OF THE NATIONAL AVERAGE FOR CENSUS REGIONS



Source: Bureau of Economic Analysis

Conclusion

Even though there is disagreement concerning the exact magnitude of future GNP growth, there is a strong consensus that we can expect substantial growth over the next five years. This extension of what is already one of the largest expansion in the post-World War II period can be attributed partially to policy changes that reflect a greater reliance upon the free market. These policy changes, as evidenced by measures such as reductions in the degree of government regulation and the adoption of a more neutral tax code, have formed the basis for new growth. They have provided a general improvement in the economic landscape by improving such variables as the inflation rate and interest rates.

This growth, however, has not occurred without cost. As we have seen, recent structural change has caused worker dislocation as manufacturing in particular has had to regroup in order to become more competitive. Rather than moving towards deindustrialization, we see a leaner—but stronger—manufacturing sector emerging.

The structural change has been accomplished by shifts in regional growth rates. Differences in regional growth have always existed, and there is no reason to expect that to change. The differentials in regional income and employment growth are the result of an uncountable number of decisions made each day by businesses and individuals on such issues as where to locate, what to produce, and what to buy. It is misleading to take a given set of growth rates for a given period and project those rates into the future, for such "trends" are unlikely to continue for very long. There is already some indication that the patterns of growth in the current business cycle have begun to change. The high-technology boom that underlies the strong growth in New England may have crested (NJ, 12/13/86) and the decline in heavy industry may be close to bottoming out.

The dynamic nature of our free market economy creates many new challenges and opportunities. Unavoidably, the price of this progress is disruption. However, with a well-trained work force and efficient capital markets, the disruption can be minimized. This should be the goal of economic policy: To facilitate progressive change, not to stop it.

Summary

Economic growth is not a smooth and uniform process. The various industrial sectors and geographic regions of the U.S. economy develop along paths determined by complex interactions of demand and supply conditions. The availability of suitable labor, the development of productivity-enhancing technoligical innovations, and the existance of sufficient output markets dictate the direction and distribution of the more aggregate measures such as GMP and unemployment.

During its development, this country has experienced periods where first agriculture, then manufacturing became a driving force in the economy by virtue of the number of jobs they generated. Even though output continues to rise in both of these sectors, the service sector has taken over as the main source of job creation and this trend is expected to continue.

The labor requirements of the service sector, in addition to the requirements of an increasingly technologically sophisticated manufacturing sector, place a strong importance on improving the quality and quantity of high school and college graduates. The projected decline in the number of new labor market entrants make this goal even more important: with fewer new workers, all will be needed to create and maintain a competitive economy.

IV. THE UNITED STATES IN THE GLOBAL ECONOMY

As the world's largest and most dynamic economy, the United States confronts a major challenge as it adjusts to the competitive realities of the late 1980s and beyond. That challenge involves our ability to retain hard-won domestic successes—i.e., low inflation, declining interest rates, and robust job growth—while improving our international economic performance. In the face of large trade and current account deficits, this will be a major task. Careful application of America's formidable competitive strengths, however, can enable us to accomplish just that.

Our underlying competitive strengths should not be underestimated. The United States has traditionally enjoyed a comparative advantage in agriculture and services. Productivity in manufacturing constitutes the decisive test for this country as it strives to regain export market shares. There are reasons for us to be confident on this front. According to the President's Council of Economic Advisers (CEA), output per hour in manufacturing has expanded at an average annual rate of 3.8 percent since third quarter 1981. This is substantially higher than the 1.5 percent growth rate in manufacturing productivity between 1973 and 1981; it also eclipses the 2.6 percent post-World War II average. Similarly, recent growth in unit labor costs has been modest. Since early 1983, it has averaged 0.8 percent. Rapid appreciation of the dollar through the first half of this decade partially nullified these gains. But decline in the value of the dollar since 1985 should now provide a powerful assist in helping the United States to translate its underlying comparative advantage into larger market shares, abroad and at home.

In sum, the United States is well positioned to reduce its external deficits by competing more effectively for sales in the global marketplace and here at home. The goal should be to reduce those imbalances in a manner which preserves, rather than destroys, the post-World War II network of multilateral commercial arrangements which still provide the best guarantee for future economic affluence and security. This goal can best be pursued through four major policy initiatives, each of which is discussed below:

Reduce the Federal budget;
Help stimulate growth abroad;
Expand U.S. exports; and
Strengthen the global trading system.

Budget Reduction.—Over the space of four years, 1982-86, the United States has been transformed from the world's largest net foreign investor to the largest capital market in the world. The magnitude of this shift is reflected in the growth of net capital inflows as a percentage of U.S. gross national product over this same four year period—moving from near zero in 1982 to a preliminary estimate of 3.5 percent in 1986.

What has caused this recent large inflow of capital into the United States and decline in capital outflows? Strong U.S. economic performance is undoubtedly a part of the explanation. This is because capital markets direct resources to those economies offering the most attractive investment opportunities. Lower taxes, enhanced incentives to invest, deregulation, and sustained, non-inflationary growth over the past 49 months have made the United States an especially attractive haven for foreign investors and lenders. Likewise, U.S. investors have chosen to keep their money here rather than invest it abroad.

But a more fundamental reason behind the large increase in capital inflows involves the inability of the United States to align government expenditures with government revenues. Foreign capital has been used to bridge the expenditure/revenue gap—enabling the United States to temporarily finance a growing budget deficit. The U.S. trade and current account deficits are a mirror reflection of all our capital account inflows. As capital inflows substitute for domestic savings in buying U.S. Treasurys to finance the budget deficits, domestic savings can go instead to buy imports of goods and services, which adds to our trade deficit.

This link between U.S. budget and external payments deficits is spelled-out in a recent Commerce Department paper:

> The critical element in producing these [external] imbalances was the uninterrupted expansion of the federal deficit from about $60 billion in 1980 to $200 billion in 1985. Absent the very large government deficits, private saving probably would have been more than adequate to meet U.S. investment needs, the dollar exchange rate would probably have been lower, and the net foreign capital inflows and the accompanying very large current account and trade deficits probably would not have occurred (p. 58, United States Trade, "Performance in 1985 and Outlook," U.S. Dept. of Commerce, October 1986).

Compared with our major competitors, Japan and West Germany, the relative size of the U.S. Federal deficit is troubling. In 1985, for example, it reached 5.4 percent of GNP, contrasted with 1.4 percent for Japan and 1.5 percent for West Germany, both of whom, not surprisingly, have been generating record current account and trade surpluses. The key goal for the United States, then, is to reduce the need for foreign capital by cutting the Federal deficit, thereby contributing to the effort of the United States to return to balance in its external accounts.

Stimulating Global Expansion.—1986's record U.S. trade deficit of $172 billion continues to reflect the divergent growth paths of the American economy and its industrial partners. Compared with the rest of the world, U.S. economic performance has been impressive throughout most of this decade. This fact is reflected in a recent OECD survey on relative purchasing power in the major industrial economies, including Canada, West Germany, France, Japan and the United States. The United States came out on top.

A brief resume of this survey is provided in the London Economist (p. 106, February 21-27, 1987).

One significant indicator of superior U.S. economic performance is job creation. Notwithstanding pockets of high regional joblessness, the U.S. employment record is impressive. With the exception of Japan, America's employment level stands favorable in comparison with its Western allies. American industry has generated 11.5 million new jobs over the last four years. No other nation's economy can match that pace. By way of contrast, since 1976 employment in Western Europe has been stagnant or even falling. As a result, by late 1986, while American unemployment stood at 7 percent of the work force, the average Western European rate was 9.5 percent.

Superior U.S. economic performance vis-a-vis its industrial partners broadly reflects differences in total national demand growth. Between 1982 and 1985, while this indicator jumped by 5.6 percent in the United States, average domestic demand grew by a modest 2.4 percent in the other major market economies. This gap between foreign and U.S. demand growth narrowed in 1986.

To be sure, some substantial benefits have derived from this divergence between the United States and its trade partners. Strong recovery in the United States during the early 1980s helped pull the rest of the world out of deep recession. The United States performed this task by providing a vital market for developed and developing country exporters. In Latin America alone, this resulted in a 95 percent increase in that region's merchandise exports to the United States between 1982 and 1984. But Latin America is hardly an exception. Over the past five years, most of our partners have relied on export sales to the United States for between one-quarter and one-half of their domestic growth. The result was that between 1981 and 1986, U.S. merchandise imports jumped from $273 billion to $387 billion.

This divergence also contributed to U.S. recovery. In its 1987 Annual Report, the President's Council of Economic Advisers explains why:

> At first, the deterioration of the U.S. payments position helped . . . the U.S. economy. During the first six quarters of the expansion, real GNP grew at a healthy 6.8 percent annual rate; domestic demand grew even faster, averaging 8.8 percent. In effect, growing net imports allowed desired increases in spending to be satisfied without pushing production growth to levels that would have caused bottlenecks. Although the strong appreciation of the dollar reduced U.S. international competitiveness, the resulting decline in import prices boosted real incomes in the United States and helped to ameliorate inflationary pressures (p. 107, Economic Report of the President, January 1987).

But this deterioration has gone far enough. For the 1981–1986 period, the U.S. trade imbalance will approach $600 billion. These cumulative imbalances are unsustainable in the long-run. As will be discussed presently, a considerable portion of the responsibility for reducing these imbalances must be undertaken by American firms and workers. Some of the adjustment must be shouldered by the United State's trade partners. How? Through stronger, domestic-led expansion in Western Europe and Japan. Such an opening would provide the United States with an important opportunity to generate new sources of growth in the domestic economy through revitalized U.S. exports. Similarly, expanded growth in key allied countries would also provide heavily indebted Third World nations with alternative export markets.

Recent U.S. efforts to get the allies to take greater responsibility for stimulating the global economy have met with mixed results. Concerns about future inflation emboldened finance ministers in Western Eurpoe and Japan to reject U.S. efforts to promote a turn away from export-led expansion and toward domestic growth, which in turn could generate a stronger demand for foreign goods.

Western Europe and Japan could indeed provide a major stimulus to global recovery through expanded imports of goods, particularly from Third World countries. While the United States continues to pull in about 60 percent of developing world manufacturing products, Western Europe's percentage remains in the 28–30 percent range, while Japan's has actually dropped from 8 to 6 percent over the past few years. This situation was recently summed up by Goldman Sachs Vice President, Robert D. Hormats before the Joint Economic Committee: ". . .popular opinion in these nations has not yet come to terms with the notion that the long-term interest of their societies will be served by their assuming a greater portion of the global economic management role that the U.S. took on after World War II."

Export Expansion.—Despite the magnitude of the U.S. trade imbalance, U.S. and global economic interests would be poorly served by crash efforts to reduce it through sharp import cutbacks. It bears remembering that the last U.S. trade surplus ($2.2 billion) was generated in 1975 in the midst of a severe recession. The large U.S. merchandise trade imbalance cannot be sustained indefinitely. So what can be done to restore balance in that account? Looking toward 1987 and beyond, one answer is to be found in expanded U.S. exports.

The growth in America's exports since 1980 has been modest indeed. But the dollar's depreciation since September 1985 along with manufacturing productivity gains should provide the United States with a major opportunity to substantially boost U.S. exports in the future.

There has been some erosion of U.S. competitiveness in certain sectors. But America's underlying comparative advantage in world markets remains strong across a broad range of products, including pharmaceuticals, petroleum refining equipment, aircraft engines, electronic computing, and medical equipment. Especially strong export prospects are provided by the service sector. Data Resources Incorporated (DRI), for example, believes that the United States can significantly improve its competitive position through expanded overseas sales of engineering and legal services, data processing, banks, airlines, plus income derived from franchising fees and technology licenses. DRI estimates that if this come to pass, the U.S. surplus in services exports could reach $170 billion by the year 2000.

But future American efforts to boost exports hinge on two other developments, namely U.S. corporate competitiveness and, more broadly on exchange rates. First, consider the American corporate position in markets outside of the United States where the cost of doing business is cheaper. According to Robert Lipsey and Irving Kravis of the National Bureau of Economic Research, nearly half of U.S. multinationals' exports derives from production outside this country. Lipsey's and Kravis's research further indicates that while U.S.-based corporations' share of world exports declined from 18 percent in 1966 to 14 percent in 1984, the global market share of U.S. owned corporations has remained at 18 percent. Their study further suggests that improved U.S. export performance substantially depends on the ability of domestic firms to boost their productivity and foreign marketing efforts.

Exchange rates constitute a larger consideration in assessing future U.S. export competitiveness. The decline of the dollar in 1986 helped contribute to a "relative" decline in the growth of America's trade deficit. This trend should strengthen in 1987 and 1988 as U.S. goods became increasingly attractive to both domestic and international purchasers—at least with respect to the Japanese and West German competition. The yen and the mark have since September 1985 appreciated 40–50 percent against the U.S. dollar.

Further significant declines in the dollar's foreign exchange value vis-a-vis these key currencies might disrupt U.S. trade relations with West Germany and Japan. A more radical "free fall" of the dollar could pose significant risks to the United States in the form of inflation caused by sharp jumps in import prices. In sum, it makes sense to give the present realignment process another year to work its effect on the U.S. trade account. That being said, some consideration might be given to efforts to lower the dollar vis-a-vis a number of other foreign currencies maintained at unfavorable parities by government intervention. Potential candidates include Canada, South Korea, and Taiwan.

Strengthen the Global Trade System.—Improved performance in the global marketplace provides the United States with the best long-run opportunity to balance its trade account. According to US Trade Representative Clayton Yeutter, "some 5 million American jobs depend on U.S. exports--more than in any other nation. The days when we could wall ourselves off from the rest of the world are gone, never to return." Growing interdependence virtually requires that a substantial portion of future U.S. domestic growth be generated from trade. The challenge facing us then is to improve our performance on that front. How? As previously mentioned, the single most important step the United States can do in this area is to reduce its budget deficit. But U.S. trade fortunes also depend on the ability of this nation to establish more open markets and equitable commercial rules to enable U.S. firms to compete more effectively. How? Through three related steps:

First, some revisions in existing U.S. trade laws are overdue. This involves imposition of firmer time limits in settling all "unfair trade practices" cases brought under Section 301 of the Trade Act of 1974; changes in Section 201 of the same Act to expand the range of relief remedies available to the Chief Executive; tightening of present antidumping and countervailing duties statutes to prevent circumvention; and stronger laws against imports which infringe U.S. patents and violate other intellectual property rights (e.g., patents and trademarks).

Second, the United States must likewise continue to press for improved market access for American firms. The Reagan Administration has accelerated these efforts over the past 18 months. In fact, more than 60 percent of all Section 301 cases have been launched under the present Administration, eight of them since September 1985 alone, of which seven have been satisfactorily resolved. These actions include Japan's agreement to open its cigarette market to American firms, and settlement of two separate 301 cases with Korea involving intellectual property rights and insurance.

Finally, the United States needs to press for stronger international trade arrangements designed to halt the spread of restrictive trade practices, running the gamut from "buy national" policies to the subsidization of ailing sectors.

Compared with most of its partners, the U.S. market is relatively open. But protectionism here, too, is on the rise. Estimates by Gary Hufbauer indicate that the amount of imports entering the United States subject to high tariffs and less-visible restraints reached 20 percent of total 1986 imports or about $80 billion worth of goods. In 1975, the comparable figure was 8 percent. The United States is hardly alone, however. Japanese protectionism has become an increasingly serious source of concern for the global trade community. Unfortunately, it is harder to pin down Japanese violations of free trade rules since most of them are based on ingrained habits in the form of traditional procurement practices. A JEC report ("Japan's Economy and Trade with the United States," December 9, 1985) addresses one aspect of this problem: "Defacto 'by Japan' procurement policies of Japan's public corporations have . . . been major impediments to selling manufactured products in Japan. The fact that approximately 115 Japanese public corporations and agencies purchase a small but significant share of all manufactured goods consumed in Japan without providing much opportunity for foreign firms to win a share of the business has been a continuing source of complaint." Japan's unwillingness to import large amounts of goods from its neighbors has been a substantial source of friction with them; and it could become a source of concern for the United States as well. Consider South Korea. One possible cause of the large U.S. trade deficit with Korea may be found in the diversion of large volumes of Korean goods from Japan's heavily protected marketplace to the more open one provided by the United States.

Negotiations will not end protectionism. They can, however, create an international censensus against such measures. The United States should devote attention to two key negotiations. The first involves a comprehensive trade agreement with Canada, the largest U.S. trade partner. Likewise, we need to press forward with a new round of multilateral trade talks under the auspices of the General Agreement on Tariffs and Trade (GATT). These bilateral and multilateral talks could be pivotal in determining whether we engage in a war of protection or work toward mutual interests with our trading partners.

Trade remains the most important growth catalyst in the world economy. Since 1945, combined world exports and imports grew between 1 and 2.5 percentage points faster than gross national product. This is because trade expansion generates domestic growth by putting each country's resources to their most productive uses. Since 1984, trade growth has slackened, and with protectionism on the rise, there is a greater need than ever to restore international economic cooperation. The U.S./Canadian negotiations can set the example. The new GATT round can broaden the consensus for trade cooperation rather than confrontation. The new GATT round comes at a crucial moment.

The United States has a strong incentive to negotiate better commercial arrangements with its trade partners. The United States left the GATT preparatory meeting in Punta del Este, Uruguay, last September with some encouraging portents—specifically, the acceptance of two key American proposals for the upcoming agenda. One was the establishment of new rules to help facilitate fairer trade in services (insurance, telecommunications, and banking, etc.). The other called for major reductions in agricultural export subsidies worldwide.

It is critical that the new GATT round be used to effectively strengthen the world's trade rules at this decisive moment in world economic history.

Summary

Underlying U.S. competitive strengths and dollar devaluation should result in future improvements in American international trade performance in 1987 and beyond. To help facilitate this process, the United States needs to reduce its budget deficit, help stimulate growth abroad, expand U.S. exports and strengthen the global trade system.

The United States is well positioned to compete in the global economy of the 1980s. In addition to increasing exports of service and agricultural goods, the key to future U.S. trade success is manufactured goods, which constitute approximately ⅔ of total U.S. exports. Since late 1981, output per hour in manufacturing has expanded at an average annual rate of 3.8 percent. Until recently these gains were substantially nullified by over-valued U.S. dollar. Now that the dollar has depreciated on foreign exchange markets, however, we can expect to reap the full advantage of domestic productivity gains in the international market.

Enhanced growth prospects abroad and strengthened trade rues would also help the United States return to a more balanced trade posture. During the first half of the 1980s, the American marketplace played a decisive role in world recovery by pulling in record volumes of imports. To keep the recovery alive and help the U.S. return to greater balance in its trade account, however, the United States is calling upon countries such as West Germany and Japan to stimulate their economies in order to absorb larger volumes of imports.

Finally, the United States needs to negotiate better commercial arrangements with its trade partners to help the U.S. adjust to changes in the global market. Key items in this regard involve bilateral negotiations on a comprehensive free trade agreement with Canada and the conduct of a new multilateral trade round.

V. FISCAL POLICY

Introduction

Fiscal policy uses the power of the government to tax and spend. Measured by the nominal growth in expenditures, this power has increased almost 10-fold since 1960. Back in 1940 the non-government sector accounted for 90 percent of gross national product. Today almost 25 percent of all the goods and services produced by the U.S. economy are absorbed by the Federal Government. The authority to tax combined with the virtually unrestrained ability to borrow has led to a massive and undesirable expansion of governmental power. Therefore it is not surprising that the size of the Federal budget has become a central issue in economic analysis. It is important for the public to understand the theory and practice of fiscal policy and how large the Government has come to be.

The Budget: Trends, Outlook, and Policy

During the last 25 years the Federal Government has greatly expended its command over economic resources. This control has been exercised directly through the budget and indirectly through regulation, court decisions, and other means. Until comparatively recently, however, the expansion of Federal expenditures was constrained by an informal acceptance of a "balanced budget rule."

Through most of American history budget deficits were regarded as a sign of moral and financial erosion. Though temporary deficits arising from war or economic downturn were tolerated, their removal was considered the first goal of Federal policy. This taboo against budget deficits was regarded as an unwritten article of the Constitution. This rule governed the policy of all major political parties. Prior to 1920, there was not even a formal fiscal year or central budget office in the Executive Branch, yet the consensus against deficit finance was absolute. Over the last few decades, however, the orthodox policy of balanced budgets has been undermined by the idea that fiscal policy should be used to fine-tune the economy. According to Nobel Laureate James Buchanan and Richard Wagner:

> * * * the pre-Keynesian norm of budget balance served to constrain spending proclivities so as to keep governmental outlays roughly within the revenue limits generated by taxes. The Keynesian destruction of this norm, without an adequate replacement, effectively removed the constraint. Predictably, politicians responded by increasing spending more than tax revenues, by creating budget deficits as a normal course of events.

In the absence of this budget constraint Federal spending grew briskly. Between 1960 and 1986, Federal outlays jumped from $92.2 billion to $989.8 billion, a rise of 973 percent. In constant 1982 dollars, this amounted to a real increase of 155 percent, and an annual average real growth rate of 4 percent. This rate of outlay expansion outpaced that of the of economy, pushing the Federal outlay share of GNP from 18 percent in 1960 to 24 percent in 1986.

Meanwhile, Federal receipts climbed from $92.5 billion in 1960 to $769 billion in 1986, a rise of 681 percent. Much of this increase resulted from unlegislated tax increases due to bracket creep. In the early 1960s less than three percent of taxpayers filing joint returns faced marginal tax rates in excess of 28 percent; by 1980 over one third faced marginal rates exceeding this level. In any event, due to bracket creep, higher social security taxes, and a variety of other factors, the government revenue share of GNP climbed from 18.3 percent in 1960 to a peacetime high of 20.1 percent in 1981, then slipped to the postwar average of 18.5 percent in 1986. Far from starving the Treasury, the controversial 1981 tax cuts merely restored the revenue share of GNP to its "normal" level.

What does this vast expansion of Federal spending mean for public policy? While the benefits of some government expenditures exceed their costs, this is clearly not always the case. At the margin, every dollar spent by the government is one less dollar available to the worker, farmer, small businessman, and consumer. To finance its expenditures, the government must tax, borrow, or inflate. At some point, government spending and taxing become excessive and government becomes a burden upon the people it is supposed to benefit. We believe that this point has been reached and that the upward trend in the share of economic resources devoted to government must be contained.

The table below illustrates the growth of the Federal budget during this period:

TABLE V-1.—OUTLAYS, RECEIPTS, AND DEFICITS

[Dollar amounts in billions]

Year	Outlays		Receipts		Deficits	
	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP
1960	$92.5	18.2	$92.5	18.3	$0.3	[1] 0.1
1965	118.2	17.6	116.8	17.4	−1.4	0.2
1970	195.6	19.8	192.8	19.5	−2.8	0.3
1975	332.3	21.8	279.1	18.3	−53.2	3.5
1980	590.9	22.1	517.1	19.4	−73.8	2.8
1985	946.3	24.0	734.1	18.6	−212.2	5.4
1986	989.8	23.8	769.1	18.5	−220.7	5.3

[1] Surplus.

While the revenue share of GNP in recent years has been close to the postwar average of 18.5 percent, the outlay share of GNP has been closer to 24 percent, about three percentage points above the postwar average. This historically high level of Federal spending has generated large deficits. If the fiscal 1986 outlay share of GNP had equaled the postwar average of 21 percent, the deficit would have been around $125 billion lower.

Deficits are dangerous because in the long run they lead to an unsustainable increase in the national debt and debt-servicing costs. These costs are passed on to future taxpayers. If the deficits bought public goods that would be available for future use, such as highways, dams, or aircraft carriers, they could be defended at least in principle. But the overwhelming majority of the deficit and new national debt reflects the explosion in transfer payments used to finance current consumption.

Notwithstanding many problems with the budget, there are signs of improvement. After the enactment of Gramm-Rudman-Hollings (G-R-H), the pace of Federal spending slowed dramatically. In fiscal 1985, total Federal outlays were up $94.5 billion—the largest increase in American history. In fiscal 1986, the first year G-R-H became effective, outlay growth slowed to a rate of 4.6 percent, which was a real growth rate of only 2 percent.

Another budget trend is the change in the composition of Federal spending. The runaway pace of Federal outlay growth has been fueled by a dramatic expansion of domestic spending. Between 1960 and 1986 transfer spending (payments for individuals) has leapt from $24.2 billion to $448 billion in 1986, an increase of 1751 percent. In real terms this reflects an increase of 432 percent. During the 1970s the growth rate was high enough to boost total outlays as well as to crowd out other parts of the budget, particularly defense spending.

Between 1960 and 1980, the share of total outlays and GNP devoted to transfer spending rose steadily. In 1960 transfer programs accounted for 26 percent of the budget and 4.8 percent of GNP. By 1980 these ratios had grown to 47 percent of the budget and 10.4 percent of GNP. Even after all the supposedly deep cuts in domestic spending mandated by the Reagan Administration, transfer payments in 1986 still amounted to 39.7 percent of the budget and 9.4 percent of GNP. Measured in constant 1982 dollars, real transfer outlays increased from $344.3 billion in 1981 to $389.4 billion in 1986, a rise of 13 percent.

In contrast, defense outlays went from 52 percent of the budget and 9.5 percent of GNP in 1960 to 22.7 percent of the budget and 5 percent of GNP in 1980. The so-called massive Reagan defense buildup pushed 1986 defense spending to 27.6 percent of the budget and 6.6 percent of GNP, still far below their levels in the early 1960s. Despite the much more serious threat now posed by Soviet military forces, U.S. defense spending, as a percentage of GNP, is about 30 percent below its 1960 level.

During this period budget priorities have been reversed. Whereas over half of the budget used to be devoted to defense, its current share is closer to 25 percent. Meanwhile, the share of the budget absorbed by transfer payments had climbed from a little over 25 percent to almost 50 percent by 1983, and only recently has started to decline. Essentially, the large increase of transfer spending has pushed total outlays higher and crowed out defense as the top spending priority of the national government.

As the deficits and national debt have mounted, net interest payments have also grown, and now comprise 13.7 percent of total annual government expenditures. Fortunately, declining interest rates have kept net interest outlays from rising sharply in recent years, but any future increase in interest rates would make a serious problem much worse.

The Table V-2 shows the composition of outlays between 1960 and 1986:

TABLE V-2.—COMPOSITION OF FEDERAL OUTLAYS AND FEDERAL OUTLAYS AS A PERCENT OF THE GNP

Federal outlays	1960		1965		1970		1975		1980		1985		1986	
	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays
Total outlays	18.2	100.0	17.6	100.0	19.8	100.0	21.8	100.0	22.2	100.0	24.0	100.0	23.8	100.0
National defense	9.5	52.2	7.5	42.8	8.2	41.8	5.7	26.0	5.0	22.7	6.4	26.7	6.6	27.6
Nondefense payments for Inds	4.8	26.2	4.9	28.0	6.5	33.1	10.1	46.2	10.4	47.0	10.8	45.0	9.4	39.7
All other grants to State and local governments	0.9	4.9	1.1	6.1	1.6	7.9	2.2	10.0	2.2	10.1	1.5	6.1	2.0	8.6
Net interest	1.4	7.5	1.3	7.3	1.5	7.4	1.5	7.0	2.0	8.9	3.3	13.7	3.3	13.7
All other	2.6	14.4	3.7	20.9	2.8	14.4	3.2	14.9	3.3	14.8	2.9	12.0	3.3	13.7
Undistributed offsetting receipts	−1.0	−5.2	−.9	−5.0	−.9	−4.4	−.9	−4.1	−.7	−3.4	−.8	−3.5	−.8	−3.3
Total nondefense	8.7	47.8	10.0	57.2	11.5	58.2	16.1	74.0	17.1	77.3	17.6	73.3	17.2	72.4

Budget Outlook

The current policy baselines calculated by both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) indicate an improving economic and budget outlook. Both forecast increased Federal revenues, decreased Federal spending growth, and a declining Federal deficit. As Table V-3 indicates, both sets of forecasts are based on reasonable economic assumptions. Table V-3 also presents the consensus projections for the same economic variables compiled by "Blue Chip Economic Indicators" from a survey of 50 top economists.

TABLE V-3.—ECONOMIC ASSUMPTIONS

[Percentage change, year to year]

	1987			1988		
	OMB	CBO	BC	OMB	CBO	BC
Real GNP	3.1	2.8	2.3	3.5	3.0	3.4
CPI	3.0	3.5	3.3	3.6	4.3	4.2
3-month T-bill	5.4	5.6	5.5	5.6	5.7	6.2
Unemployment	6.7	6.6	6.9	6.3	6.5	6.6

Based on its economic assumptions, the Congressional Budget Office forecasts an improving budget outlook under current policy, with deficits steadily declining for the next five years. According to this projection, by fiscal 1992 the deficit would fall to a level of $85 billion, or 1.4 percent of GNP.

This path of declining deficits marks a reversal of the previous trend toward larger deficits. One major cause of this change is the projected slowdown in Federal spending growth, largely due to legislated cuts in defense budget authority. Over the next five years the annual increase in Federal outlays is expected to average $59 billion. This represents a lower rate of growth than that of the economy. Consequently, the Federal outlay share of GNP will decline from 22.9 percent in 1987 to 21.1 percent in 1992.

Meanwhile, Federal revenues under current policy are projected to rise at an annual average of $77 billion over the next five fiscal years. In other words, almost $400 billion will be added to baseline revenues by fiscal 1992 without any change in the tax law. As a share of GNP, Federal revenues are expected to climb from 19.0 percent in 1987 to 19.7 percent in 1992.

Under current policy baseline deficits are projected to decline by an average of $18 billion per year. Over five years about $90 billion would be shaved from the fiscal 1992 deficit. However, it will be recalled that these projections are very sensitive to changes in economic assumptions. The budget forecast is too fragile for complacency about deficit spending, but is encouraging enough to conclude that feasible policy changes can bring the deficit under the G-R-H targets.

TABLE V-4.—CBO BASELINE PROJECTIONS

[By fiscal year]

	1986 actual	1987 base	Projections				
			1988	1989	1990	1991	1992
In billions of dollars:							
Revenues	769	834	900	962	1,050	1,138	1,220
Outlays	990	1,008	1,069	1,124	1,184	1,247	1,305
Deficit	221	174	169	162	134	109	85
Balanced Budget Act target	172	144	108	72	36	0	
Debt held by the public	1,746	1,910	2,077	2,236	2,367	2.437	2,556
As a percent of the GNP:							
Revenues	18.5	19.0	19.2	19.1	19.4	19.6	19.7
Outlays	23.8	22.9	22.8	22.3	21.9	21.5	21.1
Deficit	5.3	4.0	3.6	3.2	2.5	1.9	1.4
Debt held by the public	41.9	43.4	44.2	44.4	43.8	42.7	41.3
Reference: GNP (in billions of dollars)	4,163	4,399	4,698	5,033	5,406	5,792	6,186

Although both CBO and OMB project a declining 1988 deficit, it is still well above the Gramm-Rudman-Hollings deficit targets. With the CBO 1988 baseline deficit at $169 billion, it exceeds the G-R-H target of $108 billion by $61 billion.

Budget Policy

Since taking office in 1981, the Reagan Administration's fiscal policy has been simple and consistent. Hold the line on taxes and reduce the growth of government spending. Obviously a congressional policy calling for an expansion of domestic spending programs would put us back on the path of growing deficits.

Too often forgotten is the fact that the Congress has the primary responsibility for setting taxing and spending policy. Article I of the Constitution states. "No money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law . . ." Every dime of deficit spending must be voted by the Congress; any comprehensive effort at budget control depends on congressional action.

Nonetheless, the President is required by statute to submit a budget proposal to Congress. Though we cannot endorse every item in the President's budget, we do agree with its general approach. Continued restraint of domestic spending, no significant tax increases, and adequate funding for defense. Furthermore, it should be noted that the President's budget was submitted on time and at least technically complies with the G-R-H law. The burden is now on the budget committees and the Congress to meet the G-R-H timetable and approve a budget in compliance with the FY 1988 deficit ceiling of $108 billion.

Once again the Congress faces the opportunity to further reduce the Federal deficits. It remains to be seen whether G-R-H will be effective in enforcing fiscal discipline. Though there is much to be said in favor of other institutional reforms such as a constitutional amendment requiring a balanced budget and a line item veto, their enactment will not come soon enough to help the Congress achieve fiscal responsibility. To hit the G-R-H deficit target of $108 billion in FY 1988, the choices are also simple: Cut spending growth while not raising taxes; or reduce, maintain, or increase spending and raise taxes. Further direct pressure upon the American taxpayer by an apparently insatiable government is clearly undesirable. We do, however, support the increased use of user charges. Some Republican Members would favor additional taxes on alcohol, tobacco, and some luxury items as part of a larger package to reduce the deficit. Also, we recognize the concern of those in the Congress who foresee conditions which may make it impossible to meet the G-R-H deficit target of $108 billion for fiscal 1988 and therefore have proposed a scheduled reduction of $36 billion. We strongly feel, however, that any consideration of this option should only come at the end of the budget cycle and as a last resort.

The Theory and Practice of Fiscal Policy

The last two decades have seen a remarkable change in the attitudes of Americans towards their government. In the early 1960s, much of public policy relied on the assumption that government could manipulate macroeconomic aggregates to improve economic welfare. According to this view, the superior wisdom, motivation, and efficacy of public policymakers, in stark contrast to those in the private sector, would enable government to improve living standards, eradicate poverty, and eliminate inefficiencies resulting from "market failure." Fiscal policy, it was believed, could be used to fine-tune the economy to control business cycles and minimize unemployment.

The public's expectations with respect to government are much more modest these days. Fine tuning—and even the notion of discretionary fiscal policy—has fewer advocates than in earlier decades. The Congress implicitly repudiated the concept of fine tuning when it enacted the Gramm-Rudman-Hollings law, which mandates reduction and eventual elimination of the deficit. The decline of discretionary-fiscal policy probably has its roots in the 1970s when, on numerous occasions, the Federal Government demonstrated its ineptness.

As a result, Americans today are a bit more self-reliant and a bit more cynical. Recent years have witnessed the influence of a new way of viewing government policy-making. This new view of government is embodied in the now prominent theory of "public choice." Public choice is a school of thought drawing on elements from economics, political science, and other fields. Its influence is reflected in the 1986 award of the Nobel Prize in economics to James Buchanan, the economist who developed this theory in collaboration with a small group of colleagues.

The pubic choice approach applies economic reasoning to political decisionmaking. It dispenses with the conventional presumption that public officials always act on superior motives or knowledge. Rather, it recognizes public officials in a democracy are truly "of the people." With this distinction between the bases of private and public decision-making erased, public choice uses microeconomic theory to analyze the formulation of public policy. Public choice is useful in analyzing a wide range of policies produced under democratic decision processes.

One of the many important concepts introduced by public choice is the notion of fiscal illusion. Fiscal illusion is the distortion of the cost-benefit calculus by the way publicly provided goods and services are financed. One example is the practice of off-budget spending, under which the benefits of marginal government programs are provided to constituents at apparently no budgetary cost. The use of indirect rather than direct taxation is another practice which tends to mask the actual cost of government expenditures from the taxpayer. For example, proponents of tariffs may argue that their burden falls on foreign producers rather than on American consumers.

Probably one of the most dangerous forms of fiscal illusion is the incresase in tax revenues through bracket creep generated by inflation. Another avenue for increasing tax revenue is to play off the various income classes against one another. More government benefits can allegedly be provided, for instance, if only a small group of wealthy taxpayers are taxed more heavily. But this targeting of the rich—seen by some as a noble gesture—can be used as a smokescreen to directly or indirectly increase everyone's taxes. Another example is the practice of income tax withholding, under which tax liabilities are usually more than satisfied by tax levies periodically extracted throughout the year. While we recognize the necessity of withholding, it is likely that the tax cost of government goods would be felt more keenly if there were no withholding and taxpayers were dunned at the end of the year in one startling tax bill. As it is, most taxpayers are glad to receive their tax refunds, which amount to interest free loans to the Treasury caused by over-withholding. Under withholding, some of the sting is taken out of tax payments, and government programs appear less expensive.

Public finance textbooks often assume the existence of an objective and omniscient public authority using the instruments of taxing and spending to maximize national wellbeing. In raising a given amount of revenue, for example, traditional public finance theorists aim for a tax system which promises the best mix of efficiency, simplicity, and equity. The government is assumed to employ the principles of taxation in a disinterested manner to facilitate the raising of a predetermined amount of revenue to finance necessary expenditures. Fiscal policy instruments, it is assumed, can be finely calibrated to increased aggregate demand, improve economic performance, and to reduce unemployment. The fundamental assumption is that the elected or appointed decisionmaker is up to this daunting task.

In contract, public choice theory assumes that the actors in the political arena have neither higher nor lower motives and intelligence than others. While not devoid of interest in higher motives and fully conscious of their calling and responsibility, public officials share the same fallibility and weaknesses as everyone else.

This commonsensical view has important policy implications. For example, many types of government intervention have been justified on the basis of "market failure." Under the public choice approach the possibility of market failure would not be sufficient to compel government intervention, because this intervention, designed and implemented by imperfect human beings, would also be susceptible to failure. The burden of proof should be on the advocate of government intervention to show that a specific government action would remedy an alleged market failure without itself failing. This approach provides a more balanced and realistic framework for decisionmaking than the naive view that government officials are always able and willing to promote economic efficiency, social welfare, or any other perceived national goal.

Far from being unduly cynical about political life, the public choice literature is entirely in spirit of the founding fathers as expressed in The Federalist and elsewhere. As James Madison observed in Federalist 51: "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."

Lest one think this view was confined to Federalists, Thomas Jefferson's statement "Let no more be heard of confidence in man, but bind him down from mischief with the chains of the Constitution" is also in keeping with this view. The founding fathers and leading public choice theorists agree that restrictive groundrules in the form of a Constitution are needed to control the discretion of public officials and to protect the rights of citizens.

The Need for Budget Rules

Despite the best intentions of elected officials and their constituents, the pressures promoting deficit spending are very powerful. For most of U.S. history, and informal balanced budget rule functioned as an unwritten article of the Constitution. Desired increases in public expenditures were constrained by this postulate, which generally kept government spending and taxation within reasonable bounds. Though deficits did emerge periodically, usually as a result of war or economic downturn, these temporary deficits were a result of external forces, and were not intentional. Tragically, the shame associated with deficit spending is apparently no longer an integral part of our national character. The discipline, no longer inherent, must be imposed.

Special interest pressures upon legislators in support of expanded constituent programs can be contained by a formal balanced budget rule. This would shift the burden to program advocates to show that the value of their proposed expenditures is at least equal to those of other programs that would have to be cut back, or, alternatively, to the costs imposed by additional taxation. In other words, the potential benefits of new expenditures would have to be balanced with their costs. This would require policymakers to choose budget priorities in keeping with the level of projected tax revenues provided by law.

Rational evaluation of government program costs and resultant public benefits becomes almost impossible in the absence of a requirement to link expenditures with revenues. Spending is simply too easy. Currently, there is a treacherous asymmetry in fiscal decisionmaking. While the merits of each program are visible (and often amplified by lobbyists) the costs of the decision are not. A vote for a particular program will include the consideration that only a small part of its expense will be borne by the beneficiaries. Viewed in this context, the benefit-cost ratio of the program seemingly approaches infinity. Logrolling supported by a coalition of special interests can secure a sufficient number of votes to pass many such measures in a package. If each of these programs was forced to stand alone they would likely be defeated. Logrolling ensures blatant parochialism. What's more, by resorting to debt financing, government costs can be shifted forward onto future taxpayers. The prospect of current and future diffusion of program costs introduces and inherent spending bias into democratic legislatures. This inability to properly evalutate program costs and benefits properly is one type of "fiscal illusion." Without a specific or even general link between program expenditures and taxes, chronic overspending will continue.

Ideally, such a rule would require that each additional expenditure be linked to a specific tax measure. This earmarking would aid the Congress in making an informed judgment about whether the program was cost-effective. It would also limit the discretion of public officials regarding the disposition and possible diversion of these revenues. However, a more general rule requiring balance of aggregate revenues and outlays would still function as a powerful constraint.

The lack of a balanced budget rule distorts the taxpayers' appraisal of costs and benefits of government programs. The provision of every public good or service has price—a "tax-price." The tax-price of public good results in a certain quantity of that public of good being demanded by the taxpayer. However, if the tax-price of the good is lowered by hiding part of the tax, a corresponding increase in the demand for that public good results. In this case, the tax price may fall below the cost of providing the public good. This misallocation of resources generates economic waste.

Consider the analogy (which originated with Buchanan) of 10 people going out to dinner together under two alternative arrangements. In the first case, the diner assume that the total bill will be evenly split regardless of the cost of each meal. In the second case, an agreement is made before dinner that each diner will pay only for his own meal. Human nature being what it is, the total dinner check in the first instance will be larger than in the second.

If, under the first arrangement, one person attempts to be frugal while the others do not, he will receive only one-tenth of the savings generated by his frugality. The other diners will enjoy the same savings, while also enjoying a better meal. Thus there is little incentive to economize, and everyone will spend more than they really want to pay for. As a result, all diners are worse off.

A balanced budget rule would also tend to force the government to price public goods and services more accurately so that taxpayers could see what they were getting for their money. A shift from an artificially low tax-price to a full tax-price would inhibit demand for additional program expenditures; only those programs that are clearly seen by the public to be worthwhile would be maintained. The ability to increase government spending without specifying the source of tax financing tends to lower the apparent tax price of each unit of government goods and services, seemingly providing something for nothing. This type of fiscal illusion would be removed by a requirement that each expenditure, or at least total expenditures, must be linked to a tax measure at the time of its consideration.

Public choice theory should not be construced as a denial of an economic role for government. For example, it is clear that a certain degree of income assistance to those in poverty is deemed necessary by voters, by Congress, and by the Executive. Public choice theory then becomes useful in designing the most efficient programs possible—programs that concentrate upon aiding the poor, not upon expanding a welfare bureaucracy.

The theory of public choice—as intuitive as it is—has a great deal to offer in improving our understanding of government generally and fiscal policymaking particularly. Its lesson is that fundamental institutional reforms are necessary to change the groundrules under which public decisions are made. the development and recognition of the theory of public choice while our Nation celebrates the bicentennial of our Constitution seems particularly appropriate.

Summary

During the last 25 years the Federal Government has greatly expanded its command over economic resources. Between 1960 and 1986, Federal outlays jumped from $92.2 to $989.8 billion, a rise of 973 percent. In constant 1982 dollars, this amounted to a real increase of 154 percent, and an annual average real growth rate of 4 percent. This rate of outlay expansion outpaced that of the economy, pushing the Federal outlay share of GNP from 18 percent in 1960 to 24 percent in 1986.

The runaway pace of Federal outlay growth has been fueled by a dramatic expansion of domestic spending. Between 1960 and 1986 transfer spending has leapt from $24.2 billion to $448 billion, and increase of 1751 percent. In real terms this reflects an increase of 432 percent. During the 1970s the growth rate was high enough to boost total outlays as well as to crowd out other parts of the budget, particularly defense spending.

The rapid increase in Federal spending reflects the lack of constraints on the political system's ability to confer benefits on favored groups. Special interest measures can be formally or informally linked through logrolling, resulting in the passage of spending measures that would be defeated if considered alone on their own merits. This suggests the need for institutional constraints that would make it harder to push federal spending higher. Such constraints would establish some type of linkage between the level of Federal revenue and outlays, resulting in slower outlay growth and declining deficits. Gramm-Rudman-Hollings is one such constraint. This theory of how budget (and other governmental) decisions are made under democratic institutions is public choice. Its significance was recently recognized by the award of the Nobel Prize to the economist who developed it, James Buchanan.

The Gramm-Rudman-Hollings reform, though not perfect, has the potential of limiting spending growth. We believe Congress should meet the target by restraint of federal spending, without significant tax increases. In the event changed conditions make it absolutely impossible to meet the deficit target for fiscal 1988, a deficit reduction of $36 billion, in keeping with the spirit of GRH, might be considered at the end of the budget cycle.

VI. MONETARY POLICY

For 35 years, following World War II, the relationships among growth in nominal national product, fluctuations in the money supply, the rise and fall in interest rates, and other measures of economic performance (such as unemployment rates, the balance of payments, and industrial capacity utilization) were fairly regular and increasingly understood by economists.

The major achievement in this learning experience was the gradual acceptance by the economics perfession of insights into the central role of monetary policy. Economists at the University of Chicago are regarded as the founders of the postwar revisionist movement. They took the generally accepted neo-classical systhesis, associated with the names of J.M. Keynes, John Hansen, Paul Samuelson, Franco Modigliani, and James Tobin, and replaced its emphasis on the association between changes in the rate of growth in the money supply and the growth in nominal GNP.

By 1967 the unanimous Joint Economic Report of this committee stated, "The committee urges that the monetary authorities adopt the policy of moderate and relatively steady increases in the money supply, avoiding the disruptive effects of wide swings in the rate of increase or decrease. The committee is impressed with the increasing weight that many economists give to the importance of a steady rise in the money supply. Such rate of increase should be more or less consistent with the projected rate of growth—generally within a range of 3-5 percent per year." [90 Cong., 1st Sess., Report No. 73, Mar. 17, 1967, p. 14]

The unanimous view of the 1967 Joint Economic Report was the majority view of Congress and the law by 1978. The amendments to section 2A of the Federal Reserve Act in P.L. 95-523, the Humphrey-Hawkins Act, required the Federal Reserve to report semiannually to the Banking Committees of the Congress on monetary growth projections and to explain the relationship of the monetary growth "objectives and plans" to the short-term goals of "employment and unemployment, production, real income, productivity, Federal outlays as a proportion of gross national product, and prices" that the Act required as public policy. More pointedly, the Federal Reserve was mandated to declare annually its "objectives and plans with respect to the ranges" of money supply growth for the subsequent year.

In the light of recent experience with large increases in both budget deficits and trade deficits, monetary expansion, and the reduction in both inflation and interest rates, the accepted theoretical relationships that informed the public policy process in the previous decades seem to have changed.

The Phenomena Since 1981

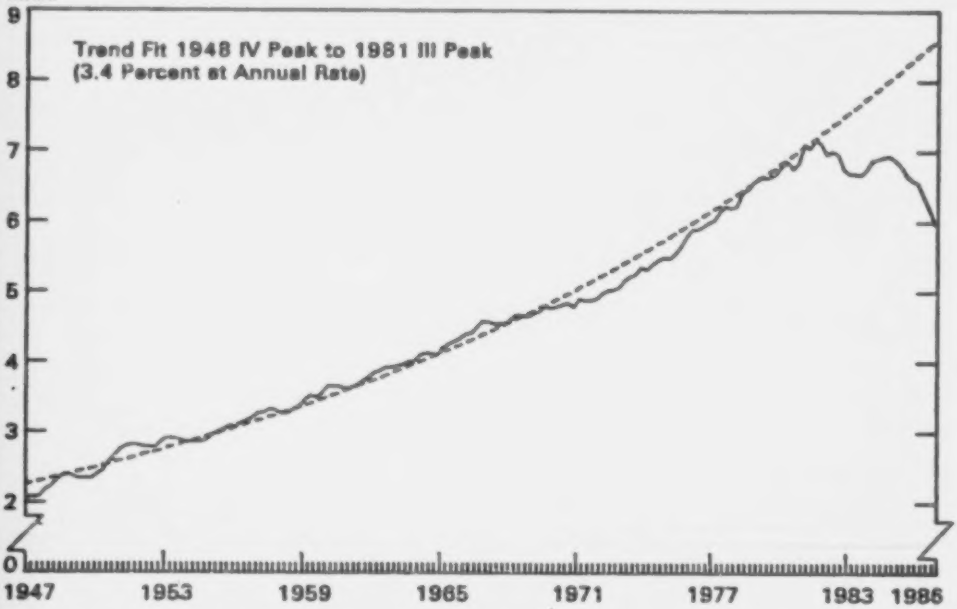
Beginning in the third quarter of 1981, major shifts in the longstanding relationships began to occur. The phenomenon of note here is the velocity of M1, the ratio of nominal GNP to the narrowly defined money supply. For 33 years, the velocity of M1 had increased at a trend rate of 3.4 percent annually. In spite of significant quarter-to-quarter shifts and a cyclical component that always made the velocity of money a centerpiece in the debate, somehow the trend in velocity always reasserted itself.

It was the underlying stability of the velocity of money that played a central persuasive role in the general acceptance of the monetarist interpretation of macroeconomics—just as it had been the seeming irrelevance of monetary policy in the 1930s and 1940s that had focused ecomomists' attention on the income-expenditures multiplier in the early postwar period. As Chart VI-1 shows, beginning with the third quarter of 1981, we can identify a period in which velocity has been declining sharply except for a brief upturn in 1983. It is this ahistorical behavior in the velocity of money that has shaken the theoretical foundations of macroeconomic theory in the past few years.

CHART VI.1

Velocity of M1

Ratio of Nominal GNP to M1



Sources: Department of Commerce and Board of Governors of the Federal Reserve System.

From December 1985 to December 1986 the M1 money supply grew 16.5 percent (15.3 percent on a fourth quarter to fourth quarter measurement). During the third quarter of 1986, it grew 17.6 percent and sustained this rate at 18.2 percent in the fourth quarter, reaching 35.1 percent in December.

A monetary growth rate of 1986 magnitudes in the 1960s or 1970s would have been highly inflationary. The CPI jumped 6.1 percent in 1969 following a 7.7 percent growth in M1 the previous year, and the CPI grew 13.3 percent in 1979 following an 8.3 percent growth in M1 the previous years—in both cases the highest rates in both price level and money supply increases in the respective decades.

On February 2, 1987, the Chairman of the Federal Reserve testified before the Joint Economic Committee, in response to a question whether these rates of expansion were excessive:

> Well, the test of whether you've got too much money chasing too few goods lies in the eating I guess. Are prices going up?
>
> Now I agree you cannot judge that instantaneously. We will know whether we had too much money a couple of years from now rather than today. Now obviously our policy, so far as I am concerned, is based upon a judgment that that is not the case. But I can't prove it to you until 1989 and some things will depend on what happens between now and 1989.

It is the decline in the velocity of money that has accommodated the rapid increase in the money supply since 1982, and has belied all predictions about rapid monetary growth leading to a resumption of inflation.

The Success of Bold Leadership

As we reported in the August 1986 JEC, *The Politics of Triumph,* the success of monetary policy in ending the inflation and bringing down the double-digit interest rates of the 1970s has been an achievement of historic proportions. In 1981, the nation's economy was in the midst of stagflation and a growing loss of confidence in our role as a world economic power. The achievement of the Reagan Administration may be underestimated by some because it reduced the crisis to only a few months. Although not as histrionic as the New Deal of the Roosevelt Administration—which holds a watershed position in American economic history precisely because the initiatives did *not* solve the economic crisis and therefore the crisis is more deeply embedded in the memories of American families—the Reagan program restored confidence in the dollar and the capacity of the U.S. economy to grow.

To a very large degree, this achievement was done with the tool of monetary policy. If we examine the published forecasts and editorial assessments in 1981 of the coming year by those economists who may be identified as Keynesian, or demand-side fiscalists, their expectations about inflation, unemployment and GNP given the tax reduction and the size of the Federal deficit, was generally for a strong GNP growth, falling unemployment and continuing inflation. Of course, the strong action of the Federal Reserve to implement the President's anti-inflation goal, and the unwavering support given to the Fed by the Administration during the extreme 1981–82 tightening, succeeded in breaking inflationary expectations. With these expectations broken, a strong monetary stimulation beginning in 1982 produced the spectacular recovery and growth of 1983–84 without the side effect of renewed inflation.

Conversely, in 1983 the adherents of monetarism, whose view of monetary velocity as a phenomenon with a long-run track record of returning to a stable trend over the post-war period, were predicting renewed inflation in 1984 or 1985. It did not happen. Indeed, the degree of monetary expansion we have seen in 1985–86 so greatly exceeds the tolerances of the monetarist model that the research agenda of many scholars in macroeconomics today has been shifted to the demand for money—the underlying process that determines the velocity of money.

Some of the most promising work in progress has been done by Robert H. Rasche of Michigan State University. In addition to important improvements in the data, some of the most valuable contributions of this work are the testing and elimination of some popular hypotheses: that deregulation of financial institutions has made monetary velocity unstable, that interest rate volatility caused it, or the trade deficit, or the tax cuts.

Clearly the velocity of money is sensitive to a complex process of interaction among market expectations of the future value of money and the opportunity costs of illiquidity. The period of experience with slowing velocity is so recent that any conclusion must be tentative, but the sensitivity of the demand for money as a function of interest rates seems to be greater now than in previous decades, and reduced inflation has contributed to the greater willingness to hold cash.

The Paradox of Success

Of course, the paradox of our success in monetary policy is that today we don't know what the "correct" monetary policy parameters for the coming year will be. Both the Congressional Budget Office and the President's Council of Economic Advisors recognize this frightening situation, but acknowledge little can be said to guide policymakers. CBO cautions:

> If the ratio between nominal GNP and the monetary aggregates suddenly rises—that is, if velocity increases—expected inflation may increase, further reducing the desire to hold money, and further increasing velocity. Similarly, a downward shift in velocity may raise fears of recession and may further reduce velocity. The possibility of such instability complicates the management of monetary policy. [*The Economic and Budget Outlook: Fiscal Years 1988–1992,* Jan. 1987, pp. 17–18.]

The Report of the Council of Economic Advisers is less analytic, but no less cautionary:

> Although the nature of the change in velocity behavior is not fully understood at this time, no plausible assessment of the change in velocity growth would imply a permanent need for such rapid money growth. . . . The difficult policy issue is one of timing—to assess when sufficient money growth has been provided to satisfy increased

> demand for money balances and to determine the extent to which money growth should be decelerated. [pp. 55-56]

The important of vigilance in monitoring the economic variables that make up the demand and supply of money during the next year cannot be overstated. In the absence of a well tested monetary explanation, and in the absence of a consensus in the financial markets about the impact on asset prices of different monetary policy actions, any change in direction of interest rates, consumer or producer price index measures, exchange rates, or even expectations about the direction of economic policy that may attend the next cycle of elections or the chairmanship of the Federal Reserve must be the subject of continuing concern to this committee in 1987.

We recommend that the Joint Economic Committee undertake a regular program of hearings during the 100th Congress to assess the research that is emerging on the velocity of money and the findings of a wide range of theoretical models on the impact of different policy variables. The Joint Economic Committee has established a notable history as the leader among all the economic policy voices: the unanimous report in 1967 cited above, the publication of *Standards for Guiding Monetary Action* in 1968, and the work leading to the adoption of P. L. 95-523 in 1978.

Summary

In the light of recent experience with large increases in both budget deficits and trade deficits, monetary expansion, and the reduction in both inflation and interest rates, the accepted theoretical relationships that informed the public policy process in the previous decades seem to have changed.

That is, from December 1985 to December 1986 the M. 1 money supply grew 16.5 percent (15.3 percent on a fourth quarter to fourth quarter measurement). during the third quarter of 1986, it grew 17.6 percent and sustained this rate at 18.2 percent in the fourth quarter, reaching 35.1 percent in December. A monetary growth rate of 1986 magnitudes in the 1960s or 1970s would clearly have been highly inflationary. Yet, in 1986, we recorded the lowest inflation rate in decades.

How can one explain this paradox? Many researchers believe that it is the decline in the velocity of money that has accommodated the rapid increase in the money supply since 1982, and thereby belied all predictions about rapid monetary growth leading to a resumption of inflation.

We urge the leadership of the Joint Economic Committee to underake a regular program of hearings during the 100th Congress to assess the research that is emerging on the velocity of money and the findings of a wide range of theoretical models on the impact of different policy variables.

VII. NEW POLICY DIRECTIONS

No government operates in a vacuum. A changing society and dynamic economy require continual evaluation of Federal policies and objectives. In the 1980s, changing global and domestic economic conditions, socioeconomic trends, and new research findings have revealed several policy areas that require the attention of policymakers, politicians, and the public.

On the economic front, the apparent decline of U.S. "competitiveness" is causing alarm. Many experts argue that the regulatory structure is impending our ability to grow. Social and economic problems are inseparable when evaluating welfare policy. Decades of accelerating Federal assistance have left many to conclude that poverty cannot be eliminated. Decades of Federal intervention in agriculture have yet to solve its distressing economic problems.

The driving force behind much of the invigorated public interest in these policy issues is the need for trade and budget deficit reduction. If funding were not such a problem itself, many of the associated Federal programs would not arouse interest, let alone concern. Within that statment is an underlying cause for policy failure: inattention. Decades-old approaches can become stale when policy instigators do not strive to improve their programs. The budget deficit problem has sobered the policymaking process and stimulated program review.

Policymakers today must perform an agile balancing act. Programs must become more efficient and better focused. They must be made to achieve more at a lower cost to the economy. Policymakers must understand how even seemingly unrelated policies are connected and interdependent. They must become aware of unintended results and disincentives that may impede their efforts. Their rhetoric must match reality.

The policy issues of this chapter—competitiveness, regulation, social welfare, and agriculture—each urgently deserves policy reform. They are linked to other broad areas of national interest and require objective analysis and bipartisan cooperation. Dealing with them successfully would contribute tremendously to the well-being and standard of living of all Americans.

Competitiveness

Much of the prevailing economic discussion among private and public sector leaders centers around *competitiveness*. This term likely will find its way into every economic policy debate of the 100th Congress, from labor and productivity issues to government intervention in the marketplace. In part, *competitiveness* is a synonym for industrial policy, where economic priorities are established by a perceived consensus of public and private leaders. It also means Uncle Sam's taking off the gloves in the international trade arena.

Competitiveness endorses those economic principles that foster, promote, and strengthen competition. In our judgment, competitive forces operating in free markets at home and abroad hold the key to economic growth, job creation, rising standards of living, and an opportunity society. Straying from the principles of competition and free and open markets in general results in lower production, higher prices, less trade, and lower standards of living for consumers and producers alike. The world is not perfect, and pure competition does not exist either. Nonetheless, the theory of pure competition is the starting point for good public policy.

The competitiveness issue has emerged out of recent concern for U.S. prominence in the world economy. Deteriorating exports, worsening balance of trade deficits, lackluster productivity growth, and sluggish investment and reduced R&D, all have contributed to the feeling that the U.S. economy is slipping. U.S. performance abroad has been hampered by barriers to trade and high exchange rates, while the U.S. market has been open to a rapid expansion of imports. Several major industries—textiles, semiconductors, and office equipment, for example—have suffered setbacks or slow growth as their domestic and foreign market shares were usurped by foreign competitors. This foreign "assault" has caused considerable dislocation for some industries. But despite the costs imposed on these industries, the remedy is *not* wholesale retaliation and protectionism.

Enhancing our prominent role in global economic affairs cannot be accomplished by imposing protectionist restraints. The sheer size of the U.S. economy involved in trade makes us vulnerable to undesired consequences. Concerns aside, we remain the world's single largest and strongest economic entity. No other country stands ready to displace us as the world's dominant economic factor. Indeed, the United States has buoyed other nations' economies with over 50 months of growth and hundreds of billions of dollars worth of imports.

Describing Competitiveness

Competitiveness refers to the ability of a nation to sustain and raise its standard of living by producing and selling goods and services both domestically and abroad, in competition with other nations. This broad definition referring to *international* competitiveness can be narrowed to describe *industrial* competitiveness—referring to the ability of an industry to compete, prosper and make a profit in a global market. Both terms are really just larger versions of the classical concept of competition in microeconomic theory, where many firms seek to maximize profits and seek their advantage in the market.

A nation's competitiveness is not static. Economies of major industrial nations are continually growing, changing, and diversifying. At the forefront of economic change are the new technologies that improve productivity and offer new goods and services. Technical change also alters the mix of capital and human resources utilized by an economy. Harnessing Western technology allowed Japan to grow despite the lack of raw materials. By adding labor value and continually improving its proficiency, Japan has amassed a sizeable share of world markets, from motor vehicles to consumer electronics. Their dedication to R&D in a range of sciences and a relatively greater willingness to save and invest may provide a competitive edge in emerging industries and new applications for years to come.

Economic theory demonstrates that countries benefit by exchanging that which can be produced "cheaper" in terms of the alternative uses of resources. This means a country can be competitive even if it is not technically superior.

Is the United States losing its competitive edge in the global economy? In some industries, perhaps, but certainly we are not in general decline. Instead, the gap between American and foreign economic performance is narrowing due to the rapid advances of other countries. The world economy of 1987 has little in common with the one of 30 years ago, when foreign trade was far less. Advances in education, training, technology, production techniques, transportation, and communications in dozens of nations have facilitated the trading process. Technologies are rapidly and easily transferred across national borders. Other countries have made tremendous progress in productivity growth, aided by substantial saving, investment, R&D, and capital formation.

In the same 30 years, U.S. public and private economic priorities have not been directed similarly. Our advances in growth and productivity have been slowed for many reasons. Lower saving rates reflect America's inclination for current rather than deferred consumption. The Federal income tax retards incentives to save. Less saving results in less (and more expensive) investment, capital formation, and R&D, other factors equal. Some analysts suggest a lack of initiative at the white collar level to apply new technology or management techniques. U.S. wages and salaries in many instances are much higher relative to their foreign counterparts. Frequently these are the same industries requesting protection from imports—auto and steel, for example Environmental and safety regulation, while necessary to a substantial degree, impose an economic penalty on U.S. business not necessarily borne by their foreign counterparts. National security expenditures, while necessary, siphon off resources and require tax burdens not endured equally elsewhere in the free world.

Indicators of Competitiveness

Measuring competitiveness is as elusive as defining it. However, several economic indicators and measures can be useful to examine the components and related factors of competitiveness. The following outline categorizes many benchmark indicators.

Economic Measures

Income.—Per capita, inflation-adjusted, after-tax income is a good indicator of changes in standards of living that can be compared among nations.

Returns on Investment.—Profitability is a strong indicator of the economic performance, efficiency, productivity, and prospects for an industry or nation.

Gross National Product.—On a per capita, real basis, output of goods and services demonstrates the economic performance of a nation *vis-a-vis* others.

Share of World GNP.—Independent of changes in domestic performance, this measure would track changes relative to other nations.

Merchandise Trade Balance.—Although service trade is growing, the lion's share of trade at present is in materials and goods. The composition of merchandise is of major importance, too, because finished goods have little "value added" potential for the importing nation.

Determinants of Competitiveness

Productivity.—Essential to the health of an economy and prosperity of society is the ability to improve the provision of goods and services. Productivity growth does not occur automatically; it has to be pursued vigorously at all levels of production. As a measurement, however, it is lacking in its present form. Services (about 60 percent of the U.S. economy) cannot be gauged like manufacturing or materials, because of the lack of a physical product. Until a precise measure is devised, productivity measures will not be accurate.

Labor Resources Investment.—Education, training, adaptability, and effort all have large economic consequences. Enhancement of workers' skills and endeavor will make a tremendous contribution to living standards.

Capital Resources Investment.—R&D, capital formation and technical applications are catalysts for working smarter and living better. Labor cannot realize its full potential without sufficient and advanced capital.

Economic Diversification.—Human wants are unlimited and insatiable; fulfilling them is human nature. The adage "supply creates its own demand" aptly depicts the phenomenon that the emergence of new products or services either elevates the value of all existing ones or replaces the old with superior ones that will serve society better.

Regulatory Climate.—Economic and social regulations can impede growth when the costs of compliance and control exceed their benefits to society. For example, economic regulation to safeguard against monopolistic power is desirable, but disallowing joint ventures between U.S. corporations on expensive, high-tech research can result in needlessly lost opportunities seized by foreign competitors.

Other Factors.—Work attitudes, resource ownership and control, the size and dominance of government, cultural practices, and consumer choices and preferences are among many factors having a pronounced effect on the economic performance of a nation. But these influences on the economy are governed more by social, religious, and political forces than by economic forces *per se.*

Economic Environment.—Even the best of firms and industries cannot withstand a poor business climate. Our own history and a survey of most Third World nations today have proven that departures from a free and open market system results in reduced well being. A sound economic foundation is necessary on three levels.

At the ground level are microeconomic practices. In a competitive market structure, firms will not survive unless their management of resources is effective and efficient. Success hinges on effective planning, cost analysis, quality control, and marketing, and on good management, labor, business, and public relations. These functions are at the heart of competitiveness.

Federal policy governs the next level, macroeconomic factors. On the domestic front, sound fiscal and monetary policy are imperative for lasting growth and competitiveness. Price stability, adequate credit resources at reasonable interest rates, fiscal policies that foster investment in the future as well as attend to current needs, and policies that reward initiative and innovation all make necessary and valuable contributions to our competitiveness.

Third, international factors require the attention of Federal policymakers. Trading arrangements are not founded solely on economic grounds. Political and cultural considerations are equally important and complex facets of international relations. Abiding by the principles of free and open trade is difficult when other countries disregard fairness. While the United States is relatively self-sufficient, our economy is still exposed to risk in a trade war. The United States is vitally integrated into the global economy; future growth depends on further expansion of world trade and U.S. exports.

Trade is affected by three conditions. First, countries must be capable of trading, by having something to exchange and the financial means to accomplish it. Developing nations saddled with external debt are in a different position. If these countries are to become a healthy part of the international economy, new policies will need to be devised by the entire international community, not just the United States.

Second, the monetary mechanism of trade—exchange rates among currencies—can be the ultimate determinant of the occurrence of trade. Ideally, exchange rates reflect an economic comparability between countries. Artificial values of currency can offset any comparative advantage or technical edge of an industry. When that occurs, the world loses a welfare gain. Obviously, the exporter loses the sale; less obvious is that the prospective importer is denied something that would make his society better off.

Third, other barriers to trade—quotas and import restrictions, inconvenient compliance requirements, excessive tariffs and the like—reveal the protectionist tendencies of all countries. Few industries are faced with as many trade barriers as is American agriculture. Despite the fact that the United States can produce more abundantly and more economically than any other country, it now penetrates the world market mostly as a residual supplier. With starvation so widespread today, food is the most important commodity, but for political, social and national security reasons, many countries will not diminish their less efficient domestic industry and risk dependency.

Improving U.S. Competitiveness

Advancing America's prominence in the global economy is a back-to-basics proposition that requires the commitment and determination of the American people and the cooperation and fairness of all governments. Furthering our competitive standing is more than an economic goal. At stake is our global leadership and national security. Global leadership is also demonstrated by being forceful in dealing with unfair trade practices of other nations.

Economic rivals are poised to compete directly with us at home and abroad. Restraint of this competition ultimately will result in lower living standards for all. Restoring free and fair trade is as much a diplomatic challenge as it is an economic necessity. Bending to protectionist pressures at home likely will result in even further deterioration of exports—and employment.

To meet the challenge, people must be prepared for a dynamic, high-tech workplace demanding more skills and flexibility. Advanced education and training are essential to the task of strengthening the U.S. economy. Parents and children, teachers and students, and labor and management working cooperatively with a sense of responsibility and obligation, can make substantial gains. American ingenuity and ambition are invaluable economic assets.

A healthy economic climate for industrial innovation is essential. This Administration's overall economic policies have accomplished much in this regard, and specific actions—such as relaxing antitrust laws applicable to limited partnerships for research and development—have been very helpful. More remains to be done, e.g., strengthening and making permanent the tax credit for research and development.

Capital resources—including foreign sources of capital—must be expanded and applied to established American business. Even our new high-tech ventures benefit from access to world capital markets. Harnessing new technology is integral to economic growth and social advancement. The price for impeding the formation of capital is slower productivity growth and therefore, the loss of competitiveness.

The United States should not seek fair play through reactionary protectionism and other trade actions imposed for political purposes and other self-defeating gestures, such as embargoes. Fairness comes from the mutual respect for and understanding of foreign societies' cultures, institutions and goals. But our trade partners must soon recognize that our patience is growing thin. Their responsibilities extend to maintaining growing economies that enable their consumers to buy more of our goods.

America's best hope for enhanced competitiveness hinges on persuasion. We must convince the world that competition in free and open markets is the proven way to elevate standards of living and is superior to any other system, imagined or contrived. That message must be heeded both at home and abroad if the world economy is to prosper, grow and realize its full potential.

Regulatory Reform

The extensive regulation debate of the Reagan years will take on a new dimension and intensity in the 100th Congress. At issue is the extent to which government regulation inhibits U.S. competitiveness. This new twist adds relevance to long-standing complaints by the private sector that many regulations are needlessly cumbersome, purposeless, and counterproductive. A few general observations are offered to assist policymakers during the deliberation of regulatory reform.

We believe that Federal regulations and compliance requirements still place an inordinate burden on American business, consumers, and taxpayers. Decades of rulemaking have resulted in a quagmire of inconsistent and conflicting directives by countless legal authorities and statutes. Furthermore, regulations by a large are promulgated in a static, permanent manner, disregarding a dynamic economic setting that requires flexibility to adapt to new technologies and markets.

Excessive regulatory burdens have contributed to the erosion of U.S. competitiveness. Paperwork, litigation, and other exhausting compliance requirements divert resources away from other more productive activities. Profits consequently are reduce, taking resources away from R&D, innovation, and investment.

Administrative initiatives addressing regulatory reform deserve congressional cooperation. Creating a centralized regulatory oversight authority (Executive Order 12291) and requiring Federal agencies to establish their regulatory agendas annually (E.O. 12498) have aided reform efforts. The number of regulations submitted to the Office of Management and Budget's Office of Information and Regulatory Affairs decreased 20 percent between 1981 and 1985. In 1985, 13 percent of all submissions were revised to modify their intent or to reduce their burden on the private sector. In contrast, only 5 percent were changed in 1981 to reduce their negative impact. The Reagan Administration has also attempted to ascertain the costs and benefits of regulations, a commendable effort to bring to light the economic ramifications.

A second Presidential task force on regulatory relief was formed in late 1986, calling for government to do all it can to improve productivity and competitiveness—an aim we support. We are convinced that the United States can maintain its regulatory safeguards in a more efficient and less costly manner thereby improving our competitive standing. As this task force and the Congress deliberate this importation issues, the following considerations have relevance and pertinence.

1. *Reverse the method of regulation from "sticks" to "carrots."*—Regulation has a bad reputation in part from the way it is implemented and enforced. Human behavior responds much more favorably to incentives than to punishment; economic behavior is not different. As an example, small businesses and their employees would be better served by Federal technical assistance on regulatory requirements (such as OSHA rules) than being fined and penalized for violating rules they didn't know existed.

2. *Do regulatory penalties fit the crime?*—Severe action for minor offenses is the archetypical regulatory burden. Minor offenses, however, can and do add up, particularly in the environmental area, and must not be ignored. Regulatory mechanisms should be capable of dealing with patterns of minor offenses.

3. *Regulation should never be a barrier to entry into an industry.*—Existing firms in an industry sometimes use regulatory controls to their advantage, resulting in unwarranted and undesired protection from potential competition.

4. *Incorporate flexibility into regulatory design.*—Rules governing the economy must adjust to changing technology and markets. As an example, the Environmental Protection Agency recently revised its approach for reducing air pollution. Instead of imposing rigid pollution control standards, industries are permitted flexibility to achieve the desired result under the "bubble" concept. The goal of pollution reduction is achieved not by equivalent reductions by each polluter, but rather by the most economical means. Pollution is best controlled by eliminating it from sources that can be cleaned up at the lowest cost; the "bubble" concept affords that flexibility while still continuing to address the more entrenched pollution problems.

5. *Regulators must seek better ways to monitor their programs.*—New technologies and oversight processes can be harnessed to reduce the cost of regulation to taxpayers and industry.

6. *Policymakers must improve international agreements to honor copyrights, patents and property rights.*—Domestically, owners are protected; the United States cannot tolerate intellectual robbery abroad.

7. *The regulation of information-age, high-tech, and other emerging industries must fully reflect global considerations.*—The United States is just one player in new markets; policymakers must develop an appreciation for that fact.

8. *Policymakers should evaluate the regulatory climates of major industrial nations to see how the United States differs.*—Such a comparison could yield new regulatory approaches and show where the United States may be at a disadvantage. This analysis also could study whether U.S. multinational corporations have been driven offshore to escape prohibitive control.

9. *America's tradition as a seedbed for innovation and invention should not be hampered by regulations and paperwork burdens.*—Upon analysis, one would find that much of today's global economic activity can be traced back to ideas and innovation fostered within the U.S. economic system. We must revitalize that rule. The loss of ingenuity because of excessive regulation and time consuming reporting requirements is an economic tragedy.

Walfare Reform

Few issues are closer to the human conscience or are more emotionally charged than the well being of all persons. A life of poverty is tragic, and unfilfilled potentials are lost conbtributions to society. Few would disagree that eradicating poverty is among the noblest of pursuits. Accomplishing that aims, however, is another matter. Two decades of monumental Federal leadership, policy initiatives, and massive spending have resulted in little progress.

Why then has our welfare policy failed to achieve its goals satifactorily? Poverty is a complex socioeconomic problem. Money and the material dimension is only a portion of its. Others have to do with attitude and behavior. Governmental initiatives lopsided in just one aspect of poverty have not succeeded. Social assistance must accommodate both the reduction of physical discomforts and the promotion of attitudes and behavior that induce independence and self-worth. The latter goals have proven difficult for government to instill; They instead are better achieved through grassroots family support, and neighborhood and community activities.

As with other policies, programs must treat causes, not symptoms. Beginning in the 1960s, many analysts concluded that economic growth alone would not reduce poverty. Suggesting the existence of *Structural poverty,* programs were proposed to eliminate the handicaps that caused people to be poor. By and large it was proposed to provide the poor with skills for and access to the labor market. Simultaneously, politicians spoke strongly against mere income transfers to help the poor. In 1964, President Johnson stated in conjunction with antipoverty legislation that "the days of the dole are numbered." Unfortunately, we are still counting, as subsequent Federal policy went in the opposite direction. Cash public assistance payments (inflation-adjusted) increased nearly 10 percent annually from 1965 to 1970, compared to a 4 percent annual rate in the decade preceding. Poverty program costs continued to soar in the 1970s. Inflation-adjusted per capita Federal pulic aid increased from about $50 in 1966 to over $200 in 1980.

Despite the rhetoric during the early stages of antipoverty programs, policymakers' philosophy apparently shifted away from *equality of opportunity and toward equality of outcome,* Politics had taken the path of least resistance. It simply was more expedient (in to short run) to provide payments to the poor than to fund programs to motivate, educate, train, and employ them. Programs to enable the poor to elevate themselves out of poverty did not prove to be as cost-effective or completely successful as envisioned, but they were not abandoned altogether. Ironically, and sadly, income transfers have not led to equality of outcome, and poverty persists despite $140 billion in Federal, state and local assistance (FY85).

Current welfare policy had created disincentive effects that make poverty programs less attractive and harder to implement. For example, income transfers give recipients a "tradeoff" to use that additional income to increase their total income (the potential undesired effect). Furthermore, a "work penalty" has been associated with welfare payments. When the working poor reach certain earned income thresholds, they can lose a portion or all of their welfare benefits. This system in effect imposes a servere "tax" on the working poor, and the cost associated with losing benefits can offset their desire and/or ability to become financially independent. Another disincentive deals with public involvement replacing or "crowding out" private welfare assistance. In 1955, 22 percent of private charitable contributions were directed toward social welfare undertakings. In 1983, only 11 percent was. By another analysis, each $1 of additional Federal welfare spending reduces private contributons by 30 cents. Although the net result is an increase in welfare spending, it is regrettable that private initiative is stifled by Federal intervention.

A discussion of welfare reform is not complete without mentioning the changing nature of "home life." Only 69 percent of Americans now live in traditional family circles headed by married couples. Another 15 percent live outside of families (live alone or with unrealated persons). The remaining 16 percent are "nontraditional" families. These consist mostly of one-parent households, 80 percent of which are headed by females. A pocket of poverty exists within this group of female-headed households. Only 37 percent of single parent families with female heads work full time, and median income for them was about $12,800 in 1984. By contrast, the median income for traditional families that year was $29,600—131 percent higher.

Experience shows that people respond to economic choices, and welfare recipients are no exception. Improving welfare programs is a necessary step toward minimizing poverty in society. Progress entails the combined efforts of both individuals and government. The following list outlines options to remedy some of the shortcomings of the welfare system.

1. *Return to the objective of equality of opportunity.*—There is no substitute for work rewarded by pay. Paychecks help persons in poverty attain a sense of self-worth, self-reliance and independence. Well-designed training programs would enable the poor to enter

the labor force, and the number of persons on welfare rolls would decline.

2. *Eliminating poverty is a teamwork proposition.*—Partnerships joining individuals, families, neighborhoods, grassroots organizations, communities, and State and Federal Governments are the best way to ensure successful results, Without the commitment of individuals and local resources, Federal efforts will be ineffective.

3. *Eliminate or reduce any disincentives inherent in current policy and encourage labor-force participation.*—The current system penalizes the working poor by taking benefits away from low income earners near the poverty threshould. An improvement would be to devise a gradual reduction in payments to working persons so that incentives to work remain intact. The low income families. The 1986 tax reform bill eases the tax liability on low incomes considerably. Earned Income Tax Credits also encourage low income families to work. Expanding this program may accomplish more than providing direct cash payments to disadvantaged families.

4. *Public sector programs should complement private sector charitable contributions and volunteerism.*—Private initiatives serve and indespensable role in social welfare programs. They should not have to compete with or be displaced by government activity.

5. *Education and training are the gateways to self-sufficiency.*—An increasingly technical economy requires adaptable and innovative laborers. Only through basic education and properly directed training can one acquire the skills for today's labor market. Today's labor market is competitive. Good jobs attract many applicants. Job seekers need motivational skills to achieve placement. Only through such endeavor can one realize his or her capabilities.

6. *Strengthen the traditional family structure.*—A family with two parents forms a nucleus for support and self-reliance that can foster economic independence. While the two-parent family is the ideal, we recognize that single-parent families are a significant portion of the poverty population in some areas; their problems must be addressed in any welfare reform so that the cycle of disadvantage is not continued.

Success in welfare programs is attained easier when economic growth expands economic opportunities. A strong U.S. economy creates jobs, and jobs can displace welfare dependency. Therefore, welfare recipients and low income families have a stake in sound Federal fiscal and monetary policies that promote stable, noninflationary growth.

Agriculture

Nowhere is the need for new policy direction more evident than in the Nation's farm program. Despite the budget deficit and the Gramm-Rudman deficit-reduction targets, unprecedented sums—$28.3 billion in FY86 alone—are being devoted to aid the agricultural secton. Although more than $100,000 is being spent this year alone for every farm family in financial stress, the industry remains in economic chaos.

Indeed, the time has come to recognize that the "cure"—Federal farm aid—is itself a large cause of the malady. There is little rational relationship between the problem and Federal farm policy. Not only is the farm program not solving the problem, but the current production-based approach is actually aggravating it is at least two ways: First, most of the aid is inequitable, being given to the largest, most well-to-do operators, thus increasing their already inherent advantages over the average farmer who is being driven off the land. Second, subsidies tied to production stimulate overproduction and price-depressing surpluses, thereby destroying the natural regulation of supply and demand by the market and guaranteeing continuing economic dislocations in the industry.

How has Federal farm policy gone so far astray? And what will it take to get the industry back on track? The following tabulations can help to provide some insight into the political imperatives involved. There is no question that a large number of farm families are struggling and that, politically speaking, their difficulties will continue to demand the attention of policy-makers. The question is whether, in the face of massive, uneven, and counterproductive farm subsidies, the Congress will come to recognize the wisdom of responding in a more appropriate fashion.

Table VII-1 displays, on a state-by-state basis, the number of farms, along with the Commodity Credit Corporation (CCC) subsidy total and the average amount per farm provided in Fiscal Year 1986. The subsidy data portrayed in this tabulation are taken from USDA's Federal Assistance Awards Data System (FAADS) and cover the following programs: commodity loans and purchases, deficiency and diversion payments, milk diversions payments, storage facilities loans and storage payments, wool payments, emergency feed, and conservation reserve.

The FY86 subsidy per state ranges from a low of $24,306 in Rhode Island to nearly $3.7 billion to Iowa. On a per farm basis, the subsidies range from an average of only $32 in Rhode Island to nearly $40,000 in North Dakota.

TABLE VII-1.—FARM AND FISCAL YEAR 1986 CCC ASSISTANCE PER STATE AND PER FARM

State	Farms [1] (thousahds)	CCC assistance	
		Total [2] (million dollars)	Per farm (dollars)
Iowa	111.0	$3,692.1	$33,262
Illinois	90.0	2,832.7	31,474
Minnesota	96.0	2,381.3	24,805
Nebraska	59.0	2,186.4	37,058
Texas	184.0	1,832.5	9,959
Missouri	115.0	1,767.2	15,367
North Dakota	34.0	1,337.8	39,347
Kansas	72.0	1,215.6	16,883
Indiana	81.0	1,157.8	14,293
California	79.0	1,058.1	13,393
Arkansas	53.0	766.0	14,452
Ohio	89.0	726.8	8,166
South Dakota	36.5	686.0	18,795
Mississippi	48.0	614.8	12,808
Wisconsin	83.0	610.2	7,352
Michigan	63.0	539.3	8,561
Colorado	26.7	503.3	18,850
Oklahoma	71.0	452.9	6,378
North Carolina	76.0	424.5	5,586
Washington	38.0	383.7	9,834
Louisiana	35.5	366.6	10,326
Kentucky	100.0	309.6	3,096

TABLE VII-1.—FARM AND FISCAL YEAR 1986 CCC ASSISTANCE PER STATE AND PER FARM—Continued

State	Farms [1] (thousahds)	CCC assistance	
		Total [2] (million dollars)	Per farm: (dollars)
Montana	23.6	286.1	12,122
Idaho	24.6	264.1	10,734
Tennessee	98.0	244.9	2,499
Florida	39.0	210.2	5,389
Georgia	50.0	191.3	3,826
Utan	13.9	178.9	12,874
Alabama	54.0	154.4	2,860
Arizona	8.5	133.3	15,686
Oregon	37.0	130.4	3,526
Virginia	55.0	128.4	2,335
New York	45.0	109.8	2,440
Pennsylvania	58.0	104.7	1,805
South Carolina	27.5	83.8	3,047
Maryland	18.0	71.8	3,988
New Mexico	13.8	68.1	4,936
Wyoming	9.0	26.6	2,950
Delaware	3.5	14.1	4,035
New Jersey	8.7	11.4	1,316
Vermont	7.0	8.5	1,210
West Virginia	20.3	7.5	371
Navada	2.5	3.0	1,191
Maine	7.8	1.7	217
Massachusetts	6.0	1.1	184
Connecticut	3.8	.8	216
Alaska	.7	.5	744
Hawaii	4.6	.3	69
New Hampshire	3.4	.2	68
Rhode Island	.8	.0	32
United States	2284.6	$28,271.1	$12,374

[1] Source: USDA's Agricultural Statistics, 1985.

[2] Source: USDA's Federal Assistance Award Data System, fiscal year 86.

Ten states received over $1 billion each in CCC assistance in FY1986. Together these 10 received approximately 70 percent of CCC aid, even though they account for only 40 percent of the farms and 44 percent of the acreage in farms. Interestingly, the value of U.S. farm real estate is split almost evenly between these 10 and all 40 of the remaining states, with each group accounting for about half of the total. On a per farm basis, the average subsidy to all U.S. farms was about $12,370.

Table VII-2 displays the total farm acreage in each state, the "base" acres eligible for subsidies under the acreage-based provisions of the farm program, and the average CCC subsidy according to each of those measures. The states are ranked in descending order on the basis of the average subsidy to all farm acres within each state, with a range of 16 cents per acre in Hawaii to nearly $110 per acre in Iowa. The U.S. average subsidy per farm acre is $27.84.

TABLE VII-2.—FARM LAND, FARM PROGRAM BASE ACRES AND CCC ASSISTANCE PER ACRE AND PER BASE ACRE BY STATE, FISCAL YEAR 1986

State	Farm acres (million)		Subsidy per acre	
	All	Base	All	Base
Iowa	33.6	17.0	$110	$217
Illinois	28.7	15.0	99	189
Minnesota	30.4	13.6	78	175
Indiana	16.4	7.7	71	151
Missouri	30.8	7.3	57	241
Arkansas	16.0	5.2	48	148
Michigan	11.4	4.1	47	131
Nebraska	47.2	14.2	46	154
Ohio	15.8	5.4	46	134
Mississippi	14.2	3.3	43	184
North Carolina	10.8	2.9	39	146
Louisiana	10.1	2.4	36	154
Wisconsin	17.7	4.4	34	138
North Dakota	40.9	18.8	33	71
California	32.8	4.7	32	224
United States	1,015.6	240.3	28	118
Maryland	2.7	.7	27	100
Kansas	48.0	21.3	25	57
Washington	16.3	4.4	23	85
Delaware	.7	.2	22	57
Kentucky	14.5	2.4	21	127
Tennessee	13.4	2.4	18	104
Idaho	14.7	3.4	18	78
Florida	13.0	.5	16	411
Utah	11.6	.5	15	356
South Dakota	44.5	11.9	15	58
South Carolina	5.5	1.6	15	54
Colorado	34.4	5.8	15	87
Georgia	13.5	3.2	14	59
Oklahoma	33.0	9.6	14	47
Texas	136.3	25.0	13	73
Alabama	11.5	1.8	13	86
Virginia	9.6	1.2	13	106
New Jersey	1.0	.2	12	72
Pennsylvania	8.7	1.2	12	84
New York	9.2	1.4	12	79
Oregon	18.0	1.8	7	73
Vermont	1.6	.0	5	200
Montana	60.9	10.2	5	28
Arizona	37.5	1.0	4	139
West Virginia	3.5	.1	2	73
Connecticut	.5	.0	2	36
Massachusetts	.7	.0	2	65
New Mexico	45.0	1.7	2	40
Maine	1.5	.1	1	24
Wyoming	34.8	.6	1	47
New Hampshire	.5	0	0	[1]
Nevada	8.8	.1	0	42
Alaska	1.5	0	0	[1]
Rhode Island	.1	.0	0	49
Hawaii	2.0	0	0	[1]

[1] These states have no farm program base acres.

Source: USDA.

If only farm-program base acres are considered, the range of subsidies extends from a high of $411 per acre in Florida to a low of about $24 in Maine. The national average per base acre was just under $118 per acre. Five states—Kentucky, Florida, Utah, Vermont, and Arizona—receive more than the national average per base acre, but significantly less than the national average when all farm acres are considered, presumably reflecting the fact that most farm acres in these states are not covered by the program.

Three states—New Hampshire, Alaska, and Hawaii—have no farm program base acres. Each received less than 50 cents per farm acre, however, and all three combined received just over $1 million of the $28 billion in FY86 CCC aid.

Table VII-3 shows the value of farm real estate (land and buildings) by state and ranks the states in descending order according to the return provided by fiscal year 1986 CCC subsidies.

TABLE VII-3.—CCC SUBSIDY RETURN ON VALUE OF FARM REAL ESTATE PER STATE, FISCAL YEAR 1986 [1]

State	Value of farm real estate (million dollars)	Subsidy return (percent)
Nebraska	20,964	10.4
Iowa	35,754	10.3
Minnesota	25,032	9.5
North Dakota	14,759	9.1
Missouri	20,433	8.6
Illinois	37,717	7.5
South Dakota	11,116	6.2
Indiana	20,651	5.6
Arkansas	13,671	5.6
Kansas	22,386	5.4
Mississippi	11,863	5.2
Michigan	11,990	4.5
United States	689,809	4.1
Ohio	17,794	4.1
Wisconsin	15,254	4.0
Colorado	15,047	3.3
North Carolina	13,659	3.1
Utah	6,066	2.9
Louisiana	12,690	2.9
Washington	14,853	2.5
Oklahoma	18,684	2.4
Idaho	11,009	2.4
Kentucky	13,142	2.4
Montana	13,559	2.1
Texas	89,229	2.1
Tennessee	13,156	1.9
California	56,965	1.9
Alabama	8,844	1.7
South Carolina	5,036	1.7
Georgia	11,676	1.6
New York	7,594	1.4
Arizona	9,949	1.3
Delaware	1,084	1.3
Maryland	5,663	1.3
Oregon	10,427	1.3
Virginia	10,587	1.2
Florida	19,853	1.1
New Mexico	7,484	.9
Pennsylvania	13,139	.8
Vermont	1,730	.5
Wyoming	6,166	.4
West Virginia	2,105	.4
New Jersey	3,420	.3
Nevada	2,034	.1
Maine	1,335	.1

TABLE VII-3.—CCC SUBSIDY RETURN ON VALUE OF FARM REAL ESTATE PER STATE, FISCAL YEAR 1986 [1]—Continued

State	Value of farm real estate (million dollars)	Subsidy return (percent)
Massachusetts	1,613	.1
Connecticut	1,604	.1
New Hampshire	780	.0
Rhode Island	243	.0

[1] Data unavailable for Alaska and Hawaii.

Source: USDA.

The average return on farm real estate provided solely by CCC subsidies in FY86 was 4.1 percent, ranging from 10.4 cents on the dollar in Nebraska to less than a tenth of a cent in New Hampshire and Rhode Island.

Some forms of governmental subsidies are capitalized into the value of farm assets, and this table shows the inflation potential of farm subsidies to be considerable in many states. The purchase of farm assets would be feasibly attractive in those states where the subsidy return is equal to or greater than the prevailing interest rate, assuming the present level of governmental largess would be continued. While farm owners' equity has plummeted almost $300 billion since 1981, the decline would have been even more dramatic in the absence of Federal subsidies. In addition, USDA estimates that almost one-half of total net farm income will be in the form of direct government payments in 1986.

In the face of subsidies of this magnitude and apparent importance, there is little wonder that strong political imperatives have arisen around the program, and that the inertia against reforms seems irrestible. Yet the economic dislocations which have resulted are obviously contrary to the national interest.

Changes in our present farm policy are necessary to ensure the future competitive vitality of American agriculture. For much of the past decade, our Nation's farmers have been plagued by a number of problems. The Congress sought to improve this situation through the enactment of the 1985 Farm Bill Many of the provisions of this law could be characterized as pluses. There were, however, offsetting minuses of significant dimensions and serious consequences.

Further change in our Nation's agricultural policy is necessary through a more market-oriented approach to our farm problems. The artifically high rates of recent years, which were set by statutory formulas instead of marketplace realities, have led to predictable price undercutting by our international competitors, resulting in the loss of foreign markets and the costly expansion of government-held inventories. The time clearly has come for new directions in farm policy.

Summary

Competitiveness, regulatory reform, welfare reform and agriculture are four issues commanding much attention in the 100th Congress. Renewed interest in these topics is driven by changing global and domestic economic conditions, socioeconomic trends and the compelling need for deficit reduction.

The competitiveness issue has emerged out of concerns for U.S. prominence in the world economy. Deteriorating exports, large balance of payments deficits, lackluster productivity growth and sluggish investment have contributed to the feeling that the U.S. economy is slipping. But retaliation and protectionism are not remedies. The sheer size of our economy that is involved in trade makes us vulnerable to undesired consequences. This section describes what competitiveness is, how it can be measured and what steps can be taken to improve it.

The private sector continues to complain about the burden of regulation, even though progress has been made in recent years. Administration efforts have stemmed the flow of regulation by stricter review and by requiring agencies of establish their regulatory agendas annually. Nine ways to improve regulation are discussed, including the use of incentives, incorporating flexibility and new monitoring methods into regulatory design, improving international agreements to protect U.S. copyrights and patents, and ensuring that regulations do not inhibit innovation and invention.

The need for welfare reform is obvious because the proverty rate in 1986 is little changed from 1965, even though Federal welfare programs have expanded to $140 billion annually. Transfer payments have not solved the problem; rather they are part of it. Current programs contain disincentives to work and achieve independence. Education and training programs are vital remedies, requiring the commitment of the disadvantaged to gain work skills and the dedication of local, State and Federal policymakers.

Agriculture is in its sixth year of lackluster economic performance. During that time, government farm programs have increased from $4 billion to $28 billion. Farm policy has not successfully addressed farm problems. Federal price supports have aggravated surplus production which in turn has driven market prices lower and made programs more costly. Second, farm program benefits are not directed toward farmers who are demonstrating the greatest need for financial assistance.

VIII. REPUBLICAN MEMBERS' AGENDA FOR THE 100TH CONGRESS

Our economic system is one of great opportunity for free enterprise. This is cause for celebration. It's the way market economies work best. This creates frustration and problems for those who desire to harness the economy's power and resources for the purpose of achieving some contrived, narrow objective. Economists and policymakers who have no desire to control or plan the economy, but still need to understand it, may feel frustrated by the difficulties posed by the size and complexity of the economy.

Understanding the economy is the primary goal of the Joint Economic Committee's work during the 100th session of Congress, and to pursue this goal we propose three lines of effort to be accomplished through activities similar to oversight of the agencies of the Federal Government that generate economic statistics:

1. Improving the measuring, reporting, and forecasting of economic conditions and performance;

2. Describing the nature and direction of the evolving U.S. economy; and
3. Unerstanding the role of the United States in the world economy and the need for policy actions to improve productivity and competitiveness.

We feel strongly that the pursuit of this agenda is in the tradition of the Committee and a responsible use of Committee resources.

Measuring economic activity is a monumental challenge in that the amount of information and data generated by the U.S. economy is comparable to the number of stars in the heavens. It is little wonder that we have progressed so slowly in our understanding, explanation, and forecasting of economic events. Yet it is upon such incomplete analysis that much well-intentioned public economic policy is based. Examples abound of policy proposals justified on inaccurate analysis. Too often these proposals become law and when implemented have little, if any, of their intended effect; they may even cause other problems, thereby stimulating a second generation of well-intentioned policy proposals.

This is not meant to be an indictment of our political system or the economics profession. On the contrary, America today is the strongest, most productive economic power in the world. Free market capitalism is the foundation of America's economy, and it continues to demonstrate that it is the best means to achieve long-term growth and expanding opportunity. Some, however, would argue that there is little cause and effect between economic research and analysis and our Nation's economic power and leadership. What needs to be of paramount national concern is the apparent unwillingness of our political system to remedy the painfully obvious shortcomings of the measurement, reporting, and forecasting of economic conditions and performance. It is an obligation of government to pursue on a continuing basis a "better" economics from a more credible and dependable base of economic information. The payoff from such an effort would be more effective public and private sector economic decisionmaking—a worthy goal and a valuable contribution of the Centennial Congress. The first item on the Republican JEC agenda for this congress, therefore, is to begin the process of improving the measuring, reporting, and forecasting of economic conditions and performance.

Describing the nature of the evolving U.S. economy is the second item on the agenda. What major economic forces are at work and where will they will lead us? The structure of American industry is changing in terms of business formation and consolidation and in its composition with respect to services, manufacturing, and agriculture. In addition, economic growth, output, consumer preferences, educational needs, public works, health, safety, environmental concerns, and a host of other economic characteristics are influenced by the demographic evolution of American society—changes in the population's size, age, and location. The increasingly significant role of minorities in U.S. society, the labor market, and the business community, will continue to have a profound effect on the direction of our economy. Government fiscal, regulatory, energy, and credit policies will also be major forces shaping the future of the U.S. economy.

Our Nation's role in the global economy is another economic issue deserving a place on our agenda. More specifically, we plan to investigate problems and opportunities associated with the growing integration of the U.S. economy into the world marketplace—as both a seller and a buyer. The U.S. trade deficit, amounting to $170 billion in 1986, raises the question of U.S. competitiveness relative to other nations. Is the trade deficit an indicator of a long-term decline in our ability to effectively compete in world markets, or is it a temporary imbalance, largely self-correcting through the ongoing devaluation of the dollar relative to the yen and the D-mark. For obvious reasons we need to know. If the problem is indeed long-term, then we need to direct resources into formulating policies to improve productivity and to secure fair international trade practices. If the problem is illusory or self-correcting, then we must avoid overindulgence in governmental actions.

DISSENTING VIEWS OF HON. OLYMPIA J. SNOWE

As with last year's report, insufficient weight is given to the inadequacy of the trade laws of the United States, and to the problems created by unfair foreign trade practices. I largely disagree throughout with the approach taken toward competitiveness and trade in general.

One of the most significant problems American industries and workers face is the utter lack of certainty with regard to our trade laws; a lack of certainty as to an eventual granting of relief, and as to the timetable involved in seeking relief. Many of the industries in my own State of Maine—footwear, potatoes, fishing and lumber—have pursued trade relief in the face of unfair foreign trading practices, yet have been met instead with a process that promises much while delivering little.

That there is a need to have strong trade laws, and to utilize those laws, is clear. The Republican Annual Report even cites one of the facts which illustrates this. "Over the past five years," the Report says, "most of our partners have relied on export sales to the United States for between one quarter and one half of their domestic growth." I believe this statistic reflects to a large extent the degree to which other nations have closed their market, through tariffs and other trade barriers, to trade in a wide range of goods.

Trade in footwear, for example, has deteriorated to the point where the United States is virtually the only open market in the world. We import some 900 million pairs of shoes annually; Japan, on the other hand, imports about one million pairs, and Brazil's tariffs effectively block any significant amount of imports.

The footwear case is one illustration of the fact that the United States is still attempting to be the economic engine pulling the world economy along behind it. Forty years ago, we were the only nation that could assume such a role; today, however, the United States should not be required, through the unfair trading practices of other nations, to maintain that role. Given the fact that we absorb 55% of all exports from lesser developing countries, while Japan absorbs only [illegible]%, the need for reform of our trade laws should be of the utmost urgency.

There are several avenues to pursue in reforming the trade laws of the United States: curtailing Presidential discretion under Sections 201 and 301; providing a fasttrack procedure for perishable agricultural goods; requiring mandatory retaliation for certain egregious trade practices; and other options as well. The key to these reforms is that our trading partners will understand that there are certain trading practices which will simply not be tolerated by the United States, and that we will act swiftly and decisively in the face of such practices.

Reforming our trade laws is an essential component of the move toward greater competitiveness in the United States; relying on the decline in the value of the dollar to turn around our trade problems ignores the fundamental problems our trade laws have created.

Further, the Report does not give sufficient attention to the problems faced by workers facing dislocation due to unfair foreign imports. Programs such as Trade Adjustment Assistance and Title III of the Job Training Partnership Act have been essential to workers in my district seeking to overcome the devastation wrought by an unchecked tide of imports. By tying worker personal benefits to participation in retraining programs, and by providing adequate funding for retraining programs, the Congress can ensure that some glimmer of hope remains for workers facing an otherwise grim trade picture.

Finally, the discussion in the Republican Report on the federal budget falls short in several instances, one of which I will raise briefly. The approach for reducing the deficit advocated herein suggests that further cuts in domestic spending are the best, and only, areas in which to pursue deficit reduction. I would suggest that the move to restrain spending in the domestic budget is no greater than the need to restrain spending in our defense budget. Dollars spent unwisely in the defense budget should be no more immune from cuts than dollars spent unwisely on domestic programs.

OLYMPIA J. SNOWE.

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